

FIRST HORIZON NATIONAL CORP  
Form 10-Q  
November 08, 2006

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549

(Mark one)

QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-15185

CIK number 0000036966

FIRST HORIZON NATIONAL CORPORATION  
(Exact name of registrant as specified in its charter)

Tennessee  
(State or other jurisdiction of  
incorporation or organization)

62-0803242  
(I.R.S. Employer  
Identification No.)

165 Madison Avenue, Memphis, Tennessee  
(Address of principal executive offices)

38103  
(Zip Code)

(901) 523-4444  
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year,  
if changed since last report)

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

Yes  No \_\_\_\_\_

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Yes  No

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

<u>Common Stock, \$.625 par value</u>	<u>124,467,143</u>
Class	Outstanding on September 30, 2006

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FIRST HORIZON NATIONAL CORPORATION

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PART I.

FINANCIAL INFORMATION

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This financial information reflects all adjustments that are, in the opinion of management, necessary for a fair presentation of the financial position and results of operations for the interim periods presented.

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**CONSOLIDATED CONDENSED  
STATEMENTS OF CONDITION**

	<b>First Horizon National Corporation</b>		
	September 30		December 31
<i>(Dollars in thousands)(Unaudited)</i>	<b>2006</b>	2005	2005
<b>Assets:</b>			
Cash and due from banks	\$ 903,482	\$ 1,036,816	\$ 945,547
Federal funds sold and securities purchased under agreements to resell	1,992,426	1,972,318	1,485,199
Total cash and cash equivalents	2,895,908	3,009,134	2,430,746
Investment in bank time deposits	17,798	6,373	10,687
Trading securities	2,512,744	2,013,535	2,133,428
Loans held for sale	2,808,991	5,158,103	4,435,343
Securities available for sale	3,982,680	2,841,633	2,912,103
Securities held to maturity (fair value of \$373 on September 30, 2006; \$391 on September 30, 2005; and \$390 on December 31, 2005)	369	383	383
Loans, net of unearned income	21,944,320	19,211,703	20,600,922
Less: Allowance for loan losses	206,829	185,029	189,705
Total net loans	21,737,491	19,026,674	20,411,217
Mortgage servicing rights, net	1,498,341	1,210,284	1,314,629
Goodwill	274,534	282,192	281,440
Other intangible assets, net	70,546	76,893	76,647
Capital markets receivables	1,027,927	1,453,451	511,508
Premises and equipment, net	441,659	404,867	408,539
Real estate acquired by foreclosure	65,224	27,856	27,410
Discontinued assets (Note 2)	939,728	129,358	163,545
Other assets	1,802,243	1,401,571	1,461,436
<b>Total assets</b>	<b>\$ 40,076,183</b>	<b>\$ 37,042,307</b>	<b>\$ 36,579,061</b>
<b>Liabilities and shareholders' equity:</b>			
Deposits:			
Checking interest and money market	\$ 4,742,122	\$ 4,331,644	\$ 4,425,664
Savings	256,834	288,903	279,408
Certificates of deposit under \$100,000 and other time	2,906,424	2,338,365	2,478,946
Certificates of deposit \$100,000 and more	11,920,226	12,497,183	10,931,695
Interest-bearing	19,825,606	19,456,095	18,115,713
Noninterest-bearing	5,458,935	5,813,207	5,201,844
Total deposits	25,284,541	25,269,302	23,317,557
Federal funds purchased and securities sold under agreements to repurchase	2,416,974	2,357,973	3,735,742
Trading liabilities	847,453	906,626	793,638
	926,292	1,217,904	802,017

Commercial paper and other short-term borrowings			
Term borrowings	5,226,772	2,000,113	3,437,643
Other collateralized borrowings	260,416	-	-
Total long-term debt	5,487,188	2,000,113	3,437,643
Capital markets payables	989,332	1,507,563	591,404
Discontinued liabilities	6,977	90,125	122,026
Other liabilities	1,311,628	1,105,090	1,136,221
Total liabilities	37,270,385	34,454,696	33,936,248
Preferred stock of subsidiary	295,274	295,274	295,274
<b>Shareholders' equity</b>			
Preferred stock - no par value (5,000,000 shares authorized, but unissued)	-	-	-
Common stock - \$.625 par value (shares authorized - 400,000,000; shares issued and outstanding - 124,467,143 on September 30, 2006; 126,002,753 on September 30, 2005; and 126,222,327 on December 31, 2005)	77,792	78,752	78,889
Capital surplus	301,857	390,430	404,964
Undivided profits	2,124,312	1,856,776	1,905,930
Accumulated other comprehensive income/(loss), net	6,563	(33,621)	(42,244)
Total shareholders' equity	2,510,524	2,292,337	2,347,539
<b>Total liabilities and shareholders' equity</b>	<b>\$ 40,076,183</b>	<b>\$ 37,042,307</b>	<b>\$ 36,579,061</b>

See accompanying notes to consolidated condensed financial statements.

Certain previously reported amounts have been reclassified to agree with current presentation.

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## CONSOLIDATED CONDENSED STATEMENTS OF INCOME

	First Horizon National Corporation			
	Three Months Ended September 30		Nine Months Ended September 30	
	2006	2005	2006	2005
<i>(Dollars in thousands except per share data)(Unaudited)</i>				
<b>Interest income:</b>				
Interest and fees on loans	\$ 416,898	\$ 299,100	\$ 1,173,832	\$ 795,477
Interest on investment securities	53,759	31,397	131,023	92,672
Interest on loans held for sale	72,135	111,572	224,309	284,554
Interest on trading securities	44,850	35,718	126,963	101,279
Interest on other earning assets	24,956	19,651	68,422	46,717
Total interest income	612,598	497,438	1,724,549	1,320,699
<b>Interest expense:</b>				
Interest on deposits:				
Savings	157	108	411	302
Checking interest and money market account	31,488	16,153	80,319	41,015
Certificates of deposit under \$100,000 and other time	32,090	20,466	86,544	56,371
Certificates of deposit \$100,000 and more	130,875	102,061	360,239	247,276
Interest on trading liabilities	19,233	23,237	57,503	60,635

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Interest on short-term borrowings	<b>66,871</b>	50,619	<b>190,495</b>	116,517
Interest on long-term debt	<b>80,263</b>	24,634	<b>198,098</b>	69,368
Total interest expense	<b>360,977</b>	237,278	<b>973,609</b>	591,484
<b>Net interest income</b>	<b>251,621</b>	260,160	<b>750,940</b>	729,215
Provision for loan losses	<b>23,694</b>	22,608	<b>60,146</b>	51,503
<b>Net interest income after provision for loan losses</b>	<b>227,927</b>	237,552	<b>690,794</b>	677,712
<b>Noninterest income:</b>				
Mortgage banking	<b>89,393</b>	140,482	<b>291,656</b>	368,237
Capital markets	<b>95,215</b>	82,158	<b>290,238</b>	272,109
Deposit transactions and cash management	<b>44,503</b>	41,268	<b>125,282</b>	113,994
Insurance commissions	<b>10,534</b>	12,673	<b>37,681</b>	40,947
Revenue from loan sales and securitizations	<b>11,830</b>	10,878	<b>35,399</b>	34,429
Trust services and investment management	<b>9,609</b>	11,299	<b>31,090</b>	33,741
Equity securities gains/(losses), net	<b>8,757</b>	(407)	<b>10,271</b>	(398)
Debt securities gains/(losses), net	-	1	<b>(78,902)</b>	1
All other income and commissions	<b>51,544</b>	48,247	<b>116,401</b>	126,530
Total noninterest income	<b>321,385</b>	346,599	<b>859,116</b>	989,590
<b>Adjusted gross income after provision for loan losses</b>	<b>549,312</b>	584,151	<b>1,549,910</b>	1,667,302
<b>Noninterest expense:</b>				
Employee compensation, incentives and benefits	<b>260,351</b>	259,583	<b>766,288</b>	744,003
Occupancy	<b>29,745</b>	26,082	<b>87,372</b>	76,161
Operations services	<b>17,976</b>	18,739	<b>52,491</b>	53,586
Equipment rentals, depreciation and maintenance	<b>17,893</b>	19,033	<b>56,015</b>	55,259
Communications and courier	<b>12,950</b>	14,352	<b>41,271</b>	40,009
Amortization of intangible assets	<b>3,233</b>	2,893	<b>9,002</b>	8,033
All other expense	<b>114,209</b>	85,493	<b>307,119</b>	239,883
Total noninterest expense	<b>456,357</b>	426,175	<b>1,319,558</b>	1,216,934
<b>Pre-tax income</b>	<b>92,955</b>	157,976	<b>230,352</b>	450,368
Provision for income taxes	<b>25,776</b>	49,862	<b>55,830</b>	143,293
<b>Income from continuing operations</b>	<b>67,179</b>	108,114	<b>174,522</b>	307,075
(Loss)/income from discontinued operations, net of tax	<b>(69)</b>	4,830	<b>210,580</b>	11,703
<b>Income before cumulative effect of changes in accounting principle</b>	<b>67,110</b>	112,944	<b>385,102</b>	318,778
Cumulative effect of changes in accounting principle, net of tax	-	-	<b>1,345</b>	-
<b>Net income</b>	<b>\$ 67,110</b>	\$ 112,944	<b>\$ 386,447</b>	\$ 318,778
Earnings per common share from continuing operations	<b>\$ .54</b>	\$ .86	<b>\$ 1.40</b>	\$ 2.45
Earnings per common share from discontinued operations, net of tax	-	.04	<b>1.69</b>	.10
Earnings per common share from cumulative effect of changes in accounting principle, net of tax	-	-	<b>.02</b>	-
<b>Earnings per common share (Note 8)</b>	<b>\$ .54</b>	\$ .90	<b>\$ 3.11</b>	\$ 2.55
Diluted earnings per common share from continuing operations	<b>\$ .53</b>	\$ .83	<b>\$ 1.36</b>	\$ 2.38
Diluted earnings per common share from discontinued operations, net of tax	-	.04	<b>1.65</b>	.09
Diluted earnings per common share from cumulative effect of changes in accounting principle, net of tax	-	-	<b>.01</b>	-
<b>Diluted earnings per common share (Note 8)</b>	<b>\$ .53</b>	\$ .87	<b>\$ 3.02</b>	\$ 2.47

<b>Weighted average common shares</b> (Note 8)	<b>124,150</b>	125,838	<b>124,431</b>	125,171
<b>Diluted average common shares</b> (Note 8)	<b>127,523</b>	129,924	<b>127,962</b>	129,135

See accompanying notes to consolidated condensed financial statements.

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## CONSOLIDATED CONDENSED STATEMENTS OF SHAREHOLDERS' EQUITY

(Dollars in thousands)(Unaudited)

	First Horizon National Corporation	
	2006	2005
Balance, January 1	\$ 2,347,539	\$ 2,040,983
Adjustment to reflect change in accounting for employee share-based compensation	-	33,151
Net income	386,447	318,778
Other comprehensive income:		
Unrealized fair value adjustments, net of tax:		
Cash flow hedges	434	-
Securities available for sale	48,373	(23,693)
Comprehensive income	435,254	295,085
Cash dividends declared	(168,065)	(161,104)
Common stock repurchased	(165,569)	(488)
Common stock issued for:		
Stock options and restricted stock	49,432	36,363
Acquisitions	486	24,893
Change in tax benefit from incentive plans	3,592	928
Adjustment to reflect change in accounting for employee stock option forfeitures	(1,780)	-
Stock-based compensation expense	9,635	22,526
<b>Balance, September 30</b>	<b>\$ 2,510,524</b>	<b>\$ 2,292,337</b>

See accompanying notes to consolidated condensed financial statements.

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## CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Dollars in thousands)(Unaudited)

	First Horizon National Corporation	
	Nine Months Ended September 30	
	2006	2005
<b>Operating Activities</b>		
Net income	\$ 386,447	\$ 318,778
Adjustments to reconcile net income to net cash provided/(used) by operating activities:		
Provision for loan losses	60,146	51,503
Provision for deferred income tax	55,830	32,936
Depreciation and amortization of premises and equipment	39,787	38,303
Amortization and impairment of mortgage servicing rights	-	178,363

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	Amortization of intangible assets	9,227	10,320
	Net other amortization and accretion	61,137	62,973
	(Increase)/decrease in derivatives, net	(164,317)	104,709
	Market value adjustment on mortgage servicing rights	(35,830)	-
	Provision for foreclosure reserve	9,266	5,005
	Cumulative effect of changes in accounting principle	(1,345)	-
	Gain on divestiture	(208,581)	-
	Stock-based compensation expense	9,635	20,928
	Excess tax benefit from stock-based compensation arrangements	(3,592)	(928)
	Equity securities (gains)/losses, net	(10,271)	397
	Debt securities losses, net	78,902	-
	Net losses on disposal of fixed assets	3,193	140
	Net (increase)/decrease in:		
	Trading securities	(379,316)	(336,344)
	Loans held for sale	1,622,682	32,750
	Capital markets receivables	(516,419)	(1,177,153)
	Interest receivable	(22,284)	(49,819)
	Other assets	(1,170,479)	(508,439)
	Net increase/(decrease) in:		
	Capital markets payables	398,005	1,117,240
	Interest payable	49,066	47,454
	Other liabilities	40,448	(83,485)
	Trading liabilities	53,815	480,283
	Total adjustments	(21,295)	27,136
	Net cash provided by operating activities	365,152	345,914
<b>Investing Activities</b>	Maturities of held to maturity securities	15	59
	Available for sale securities:		
	Sales	2,283,907	56,844
	Maturities	514,301	327,646
	Purchases	(3,848,857)	(581,159)
	Premises and equipment:		
	Sales	44	739
	Purchases	(75,967)	(67,781)
	Net increase in loans	(1,465,040)	(2,727,561)
	Net increase in investment in bank time deposits	(7,111)	(1,044)
	Proceeds from divestitures, net of cash and cash equivalents	280,041	-
	Acquisitions, net of cash and cash equivalents acquired	(487)	(841,950)
	Net cash used by investing activities	(2,319,154)	(3,834,207)
<b>Financing Activities</b>	Common stock:		
	Exercise of stock options	49,448	36,543
	Cash dividends paid	(167,551)	(159,961)
	Repurchase of shares	(165,569)	(488)
	Excess tax benefit from stock-based compensation arrangements	3,592	928
	Long-term debt:		

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Issuance	<b>2,234,160</b>	300,000
Payments	<b>(189,667)</b>	(901,574)
Issuance of preferred stock of subsidiary	-	295,400
Net increase/(decrease) in:		
Deposits	<b>1,848,370</b>	5,440,940
Short-term borrowings	<b>(1,194,493)</b>	165,676
Net cash provided by financing activities	<b>2,418,290</b>	5,177,464
Net increase in cash and cash equivalents	<b>464,288</b>	1,689,171
Cash and cash equivalents at beginning of period	<b>2,431,620</b>	1,320,499
Cash and cash equivalents at end of period	<b>2,895,908</b>	3,009,670
Cash and cash equivalents from discontinued operations at beginning of period, included above	\$ <b>874</b>	\$ 1,115
Cash and cash equivalents from discontinued operations at end of period, included above	-	536
Total interest paid	<b>923,139</b>	543,315
Total income taxes paid	<b>105,799</b>	117,451

See accompanying notes to consolidated condensed financial statements.

Certain previously reported amounts have been reclassified to agree with current presentation.

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## Note 1 - Financial Information

The unaudited interim consolidated financial statements of First Horizon National Corporation (FHN), including its subsidiaries, have been prepared in conformity with accounting principles generally accepted in the United States of America and follow general practices within the industries in which it operates. This preparation requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates and assumptions are based on information available as of the date of the financial statements and could differ from actual results. In the opinion of management, all necessary adjustments have been made for a fair presentation of financial position and results of operations for the periods presented. The operating results for the interim 2006 periods are not necessarily indicative of the results that may be expected going forward. For further information, refer to the audited consolidated financial statements in the 2005 Annual Report to shareholders.

**Real Estate Acquired by Foreclosure.** Prior to 2006, properties acquired by foreclosure in compliance with HUD servicing guidelines were classified as receivables in "Other assets" on the Consolidated Condensed Statements of Condition. Beginning in 2006, these properties are included in "Real estate acquired by foreclosure" and are carried at the estimated amount of the underlying government insurance or guarantee. On September 30, 2006, FHN had \$21.7 million in these foreclosed properties. All other real estate acquired by foreclosure consists of properties that have been acquired in satisfaction of debt. These properties are carried at the lower of the outstanding loan amount or estimated fair value less estimated cost to sell the real estate. Losses arising at foreclosure are charged to the appropriate reserve. Required developmental costs associated with foreclosed property under construction are capitalized and included in determining the estimated net realizable value of the property, which is reviewed periodically, and any write-downs are charged against current earnings.

**Loans Held for Sale and Securitization and Residual Interests.** FHN's mortgage lenders originate first-lien mortgage loans (the warehouse) for the purpose of selling them in the secondary market, primarily through proprietary and agency securitizations, and to a lesser extent through loan sales. In addition, FHN evaluates its liquidity position in



conjunction with determining its ability and intent to hold loans for the foreseeable future and sells certain of the second-lien mortgages and home equity lines of credit (HELOC) it produces in the secondary market through securitizations and loan sales. Loan securitizations involve the transfer of the loans to qualifying special purposes entities (QSPE) that are not subject to consolidation in accordance with Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (SFAS No. 140). FHN generally retains the right to service the transferred loans.

Loans held for sale include loans originated or purchased for resale, together with mortgage loans previously sold which loans may be unilaterally called by FHN. Loans held for sale are recorded at the lower of aggregate cost or fair value. The carrying value of loans held for sale is net of deferred origination fees and costs. Net origination fees and costs are deferred on loans held for sale and included in the basis of the loans in calculating gains and losses upon sale. Also included in the lower of cost or fair value analysis are the estimated costs and fair values of first-lien mortgage loan commitments. The cost basis of loans qualifying for fair value hedge accounting under Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS No. 133), is adjusted to reflect changes in fair value. Gains and losses realized from the sale of these assets, whether sold directly or through securitization, and adjustments to fair value are included in noninterest income.

Mortgage loans insured by the Federal Housing Administration (FHA) and mortgage loans guaranteed by the Veterans Administration (VA) are generally securitized through the Government National Mortgage Association (GNMA). Conforming conventional loans are generally securitized through government-sponsored enterprises (GSE) such as the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). In addition, FHN has completed proprietary securitizations of nonconforming first-lien and second-lien mortgages and HELOC, which do not conform to the requirements for sale or securitization through government agencies or GSE. Most of these securitizations are accounted for as sales; those that do not qualify for sale treatment are accounted for as financing arrangements.

Interests retained from the sales include mortgage servicing rights (MSR) and various financial assets. Prior to 2006, all of these retained interests were initially valued by allocating the total cost basis of the loan between the security or loan sold and the retained interests based on their relative fair values at the time of securitization or sale. The retained interests, other than MSR, were carried at fair value as a component of trading securities on the Consolidated Condensed Statements of Condition, with realized and unrealized gains and losses included in current earnings as a component of noninterest income on the Consolidated Condensed Statements of Income. With the adoption of Statement of Financial Accounting Standards No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140" (SFAS No. 156), MSR are initially valued at fair value, and the remaining retained interests are initially valued by allocating the remaining cost basis of the loan between the security or loan sold and the remaining retained interests based on their relative

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**Note 1 - Financial Information (continued)**

fair values at the time of securitization or sale. All retained interests, including MSR, are carried at fair value. The financial assets retained are included as a component of trading securities on the Consolidated Condensed Statements of Condition, with realized and unrealized gains and losses included in current earnings as a component of noninterest income on the Consolidated Condensed Statements of Income.

Financial assets retained in a securitization may include certificated residual interests, excess interest (structured as interest-only strips), interest-only strips, principal-only strips, or subordinated bonds. Residual interests represent rights to receive earnings to the extent of excess income generated by the underlying loans. Excess interest represents rights to receive interest from serviced assets that exceed contractually specified rates. Principal-only strips are principal cash flow tranches and interest-only strips are interest cash flow tranches. Subordinated bonds are bonds

with junior priority. All financial assets retained from a securitization are recognized on the balance sheet in trading securities at fair value.

The fair values of the certificated residual interests, the excess interest, and the interest-only strips are determined using market prices from closely comparable assets such as MSR that are tested against prices determined using a valuation model that calculates the present value of estimated future cash flows. To determine the fair value of the principal-only strips, FHN uses the market prices from comparable assets such as publicly traded FNMA trust principal-only strips that are adjusted to reflect the relative risk difference between readily marketable securities and privately issued securities. The fair value of subordinated bonds is determined using a spread to an interpolated Treasury rate, which is supplied by broker dealers. The fair value of these retained interests typically changes based on changes in the discount rate and differences between modeled prepayment speeds and credit losses and actual experience.

On January 1, 2006, FHN began initially recognizing all classes of MSR at fair value and elected to irrevocably continue application of fair value accounting to its MSR. Classes of MSR are determined in accordance with FHN's risk management practices and market inputs used in determining the fair value of the servicing asset. Since sales of MSR tend to occur in private transactions and the precise terms and conditions of the sales are typically not readily available, there is a limited market to refer to in determining the fair value of MSR. As such, like other participants in the mortgage banking business, FHN relies primarily on a discounted cash flow model to estimate the fair value of its MSR. This model calculates estimated fair value of the MSR using predominant risk characteristics of MSR such as interest rates, type of product (fixed vs. variable), age (new, seasoned, or moderate), agency type and other factors. FHN uses assumptions in the model that it believes are comparable to those used by brokers and other service providers. FHN also periodically compares its estimates of fair value and assumptions with brokers, service providers, and recent market activity and against its own experience.

Prior to 2006, MSR were initially valued by allocating the total carrying value of the loan between the loan, MSR and other retained interests based on their relative fair values, and were thereafter valued at the lower of cost or fair value. MSR were amortized over the period of and in proportion to the estimated net servicing revenues. The cost basis of MSR qualifying for SFAS No. 133 fair value hedge accounting was adjusted to reflect changes in fair value. MSR were periodically evaluated for impairment. Impairment occurred when the current fair value of the servicing right was less than its recorded value. A quarterly value impairment analysis was performed using a discounted cash flow analysis which was disaggregated by strata representing predominant risk characteristics, including fixed rate and adjustable loans. Impairment, if any, was recognized through a valuation allowance for individual strata. However, if the impairment was determined to be other than temporary, a direct write-off of the asset was made. With the adoption of SFAS No. 156, MSR are valued at fair value, both initially and prospectively; impairment tests are no longer performed.

**Equity Compensation.** FHN accounts for its employee stock-based compensation plans using the grant date fair value of an award to determine the expense to be recognized over the life of the award. For awards with service vesting criteria, expense is recognized using the straight-line method over the requisite service period (generally the vesting period) and is adjusted for anticipated forfeitures. For awards vesting based on a performance measure, anticipated performance is projected to determine the number of awards expected to vest, and the corresponding aggregate expense is adjusted to reflect the elapsed portion of the performance period. The fair value of equity awards with cash payout requirements, as well as awards for which fair value cannot be estimated at grant date, are remeasured each reporting period through vesting date.

For all stock option awards granted prior to adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123-R), FHN permits vesting of the option to continue after retirement. To account for these stock option awards, FHN uses the nominal vesting period approach. Under the nominal vesting period approach, awards granted to employees near retirement eligibility are expensed over the option's normal vesting period until an employee's actual retirement date, at which point all remaining unamortized

compensation expense is immediately accelerated. Awards granted after the adoption of SFAS No. 123-R are amortized

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**Note 1 - Financial Information (continued)**

using the nonsubstantive vesting methodology. The nonsubstantive vesting methodology requires that expense associated with options that continue vesting after retirement be recognized over a period ending no later than an employee's retirement eligibility date. Had FHN followed the nonsubstantive vesting period method for all awards previously granted, the effect of the change in expense attribution on earnings and per share amounts would have been negligible.

**Accounting Changes.** Effective January 1, 2006, FHN elected early adoption of SFAS No. 156. This amendment to SFAS No. 140 requires servicing rights be initially measured at fair value. Subsequently, companies are permitted to elect, on a class-by-class basis, either fair value or amortized cost accounting for their servicing rights. FHN elected fair value accounting for its MSR. Accordingly, FHN recognized the cumulative effect of a change in accounting principle totaling \$.2 million, net of tax, representing the excess of the fair value of the servicing asset over the recorded value on January 1, 2006.

FHN also adopted Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections" (SFAS No. 154), as of January 1, 2006. SFAS No. 154 requires retrospective application of voluntary changes in accounting principle. A change in accounting principle mandated by new accounting pronouncements should follow the transition method specified by the new guidance. However, if transition guidance is not otherwise specified, retrospective application will be required. SFAS No. 154 does not alter the accounting requirement for changes in estimates (prospective) and error corrections (restatement). The adoption of SFAS No. 154 did not affect FHN's reported results of operations.

FHN adopted SFAS No. 123-R as of January 1, 2006. SFAS No. 123-R requires recognition of expense over the requisite service period for awards of share-based compensation to employees. The grant date fair value of an award will be used to measure the compensation expense to be recognized over the life of the award. For unvested awards granted prior to the adoption of SFAS No. 123-R, the fair values utilized equal the values developed in preparation of the disclosures required under the original SFAS No. 123. Compensation expense recognized after adoption of SFAS No. 123-R incorporates an estimate of awards expected to ultimately vest, which requires estimation of forfeitures as well as projections related to the satisfaction of performance conditions that determine vesting. As permitted by SFAS No. 123-R, FHN retroactively applied the provisions of SFAS No. 123-R to its prior period financial statements. The Consolidated Condensed Statements of Income were revised to incorporate expenses previously presented in the footnote disclosures. The Consolidated Condensed Statements of Condition were revised to reflect the effects of including equity compensation expense in those prior periods. Additionally, all deferred compensation balances were reclassified within equity to capital surplus. Since FHN's prior disclosures included forfeitures as they occurred, a cumulative effect adjustment, as required by SFAS No. 123-R, of \$1.1 million net of tax, was made for unvested awards that are not expected to vest due to anticipated forfeiture.

Effective December 31, 2005, FHN adopted FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" (FIN 47). FIN 47 requires recognition of a liability at the time of acquisition or construction for assets that will require certain remediation expenditures when the assets are removed from service. FIN 47 clarified that future expenses to remove asbestos from buildings should be estimated and accrued as a liability at the time of acquisition with an offset to increase the cost of the associated structure. FHN currently owns certain buildings that contain asbestos. As a result of adopting FIN 47, FHN recognized a cumulative effect of a change in accounting principle equaling \$3.1 million, net of tax. FHN increased the value of its recorded tangible assets by \$4.5 million at the time it recognized an associated conditional retirement obligation in the amount of \$9.4 million.

Effective January 1, 2005, FHN adopted AICPA Statement of Position 03-3, "Accounting for Loans or Certain Debt Securities Acquired in a Transfer" (SOP 03-3), which modifies the accounting for certain loans that are acquired with evidence of deterioration in credit quality since origination. SOP 03-3 does not apply to loans recorded at fair value, revolving loans, or to mortgage loans classified as held for sale. SOP 03-3 limits the yield that may be accreted on applicable loans to the excess of the cash flows expected, at acquisition, to be collected over the investor's initial investment in the loan. SOP 03-3 also prohibits the "carrying over" of valuation allowances on applicable loans. The impact of adopting SOP 03-3 was immaterial to the results of operations.

In November 2005, the FASB issued FSP FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" (FSP FAS 115-1), which supersedes the previously deferred recognition guidance of EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" (EITF 03-1). FSP FAS 115-1 was effective January 1, 2006, and references previously existing GAAP. Therefore, adoption of FSP FAS 115-1 did not impact FHN's accounting for other-than-temporary impairment of investments.

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**Note 1 - Financial Information (continued)**

***Accounting Changes Issued but Not Currently Effective.*** In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Financial Instruments" (SFAS No. 155), which permits fair value remeasurement for hybrid financial instruments that contain an embedded derivative that otherwise would require bifurcation. Additionally, SFAS No. 155 clarifies the accounting guidance for beneficial interests in securitizations. Under SFAS No. 155, all beneficial interests in a securitization would require an assessment in accordance with SFAS No. 133 to determine if an embedded derivative exists within the instrument. SFAS No. 155 is effective for fiscal years beginning after September 15, 2006. FHN is currently assessing the financial impact of adopting SFAS No. 155.

In July 2006, FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48) was issued. FIN 48 provides guidance for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on the classification and disclosure of uncertain tax positions in the financial statements. Adoption of FIN 48 requires a cumulative effect adjustment to the beginning balance of retained earnings for differences between the tax benefits recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption. FIN 48 is effective for fiscal years beginning after December 15, 2006. FHN is continuing to assess the effects of adopting FIN 48.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS No. 157), which establishes a hierarchy to be used in performing measurements of fair value. SFAS No. 157 emphasizes that fair value should be determined from the perspective of a market participant while also indicating that valuation methodologies should first reference available market data before using internally developed assumptions. Additionally, SFAS No. 157 provides expanded disclosure requirements about fair value measurement. SFAS No. 157 is effective prospectively for fiscal years beginning after November 15, 2007, with early adoption permitted for fiscal years in which financial statements have not been issued. FHN is currently assessing the financial impact of adopting SFAS No. 157.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)" (SFAS No. 158), which requires the recognition of the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in the statement of condition. SFAS No. 158 does not change measurement or recognition requirements for periodic pension and postretirement costs. SFAS No. 158 also provides that changes

in the funded status of a defined benefit postretirement plan should be recognized in the year such changes occur through comprehensive income. Additionally, SFAS No. 158 requires that the annual measurement date of a plan's assets and liabilities be as of the date of the financial statements. Upon adoption of SFAS No. 158, unrecognized transition assets and obligations, unrecognized actuarial gains and losses, and unrecognized prior service costs and credits will be recognized as a component of accumulated other comprehensive income. SFAS No. 158 is effective for fiscal years ending after December 15, 2006, for funded status recognition and related disclosure requirements, with a one-time adjustment to the statement of condition. For measurement date requirements, SFAS No. 158 is effective for fiscal years ending after December 15, 2008. FHN expects a reduction in equity of between \$60 million and \$90 million upon adoption of SFAS No. 158.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB No. 108). SAB No. 108 requires that companies assess the impact on both the balance sheet and income statement when quantifying and evaluating the materiality of a misstatement. Under SAB No. 108, adjustment of financial statements is required when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors. Upon adoption, prior year errors, which had previously been considered immaterial but are considered material based on the guidance in SAB No. 108, should be recognized by either restating prior year financial statements or recording a one-time transitional cumulative effect adjustment to retained earnings. SAB No. 108 is effective for annual periods ending after November 15, 2006. FHN is currently assessing the guidance of SAB No. 108.

In September 2006, the consensus reached in EITF Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements" (EITF 06-4) was ratified by the FASB. EITF 06-4 requires that a liability be recognized for contracts written to employees which provide future postretirement benefits that are covered by endorsement split-dollar life insurance arrangements as such obligations are not effectively settled upon entering into the related insurance arrangements. EITF 06-4 is effective for fiscal years beginning after December 15, 2007, with the guidance applied using either a retrospective approach or through a cumulative-effect adjustment to beginning retained earnings. FHN is currently assessing the financial impact of adopting EITF 06-4.

#### **Note 1 - Financial Information (continued)**

In September 2006, the consensus reached in EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance" (EITF 06-5) was ratified by the FASB. EITF 06-5 provides that in addition to the recognition of an asset for the amount that could be realized for a life insurance contract as of the balance sheet date, the amount recognized should also take into consideration certain other amounts included in a policy's contractual terms. Additionally, EITF 06-5 requires that the determination of the amount that could be realized under an insurance contract be performed at the individual policy level. EITF 06-5 is effective January 1, 2007, with the guidance applied using either a retrospective approach or through a cumulative-effect adjustment to beginning retained earnings. FHN does not anticipate that the effect of adopting EITF 06-5 will be material to its results of operations.

#### **Note 2 - Acquisitions/Divestitures**

On June 28, 2006, First Horizon Merchant Services, Inc. (FHMS) sold all of the outstanding capital stock of Global Card Services, Inc. (GCS), a wholly-owned subsidiary. As a result, tax benefits of \$4.2 million were recognized associated with the difference between FHMS' tax basis in the stock and net proceeds from the sale.

On March 1, 2006, FHN sold substantially all the assets of its national merchant processing business conducted primarily through FHMS and GCS. The sale was to NOVA Information Systems (NOVA), a wholly-owned subsidiary of U.S. Bancorp. This transaction resulted in a pre-tax gain of approximately \$340 million. In addition, a supplement to the purchase price may be paid to FHN if certain performance goals are achieved during a period following closing. This divestiture was accounted for as a discontinued operation, and prior periods were adjusted to exclude the impact of merchant operations from the results of continuing operations. In conjunction with the sale, FHN entered into a transitional service agreement with NOVA to provide or continue on-going services such as telecommunications, back-end processing and disaster recovery until NOVA converts the operations to their systems. On September 30, 2006, discontinued assets primarily consist of operating receivables due from NOVA from post-sale activity.

On December 9, 2005, First Tennessee Bank National Association (FTBNA) sold three financial centers in Dyersburg, Tennessee, to First South Bank. This transaction resulted in a divestiture gain of \$7.0 million. Immediately preceding the sale, the financial centers had loans of approximately \$80 million and deposits of approximately \$70 million.

On August 26, 2005, FHN acquired West Metro Financial Services Inc. (West Metro), a Georgia bank holding company. West Metro was merged with and into FHN. At the same time West Metro's subsidiary, First National Bank West Metro, with total assets of approximately \$135 million, loans of approximately \$115 million, and deposits of approximately \$120 million, was merged with and into FTBNA. Total consideration of \$32 million, consisting of approximately \$11 million in cash and \$21 million in FHN shares (approximately 518,000 shares of common stock), exceeded the estimated fair value of tangible assets and liabilities acquired by approximately \$16 million. Intangible assets totaling approximately \$3 million have been identified and are being amortized over their expected useful lives. The acquisition was immaterial to FHN.

On April 1, 2005, FTBNA acquired substantially all of the assets of MSAver Resources, L.L.C. of Overland Park, Kansas, a national leader in administering health savings accounts. The acquisition was immaterial to FHN.

On March 1, 2005, First Horizon Home Loan Corporation, a subsidiary of FTBNA, acquired Greenwich Home Mortgage Corporation of Cedar Knolls, New Jersey, for an initial payment of approximately \$7.8 million in cash and FHN common stock. Net assets purchased, combined with the operating performance of the acquired business, will impact future payments owed to the sellers. The acquisition was immaterial to FHN. In 2006 additional payments of approximately \$1.1 million in cash and FHN common stock were made.

On January 7, 2005, FHN's capital markets division, FTN Financial, completed the acquisition of the assets and operations of the fixed income business of Spear, Leeds & Kellogg (SLK), a division of Goldman Sachs & Co. for approximately \$150.0 million in cash. Total consideration paid exceeded the estimated fair value of tangible and identified intangible assets and liabilities acquired by approximately \$97 million. Intangible assets totaling approximately \$55 million have been identified and are being amortized over their expected useful lives. The acquisition was immaterial to FHN.

In addition to the acquisitions mentioned above, FHN also acquires assets from time to time in transactions that are considered business combinations but are not material to FHN individually or in the aggregate.

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### Note 3 - Loans

The composition of the loan portfolio is detailed below:

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<i>(Dollars in thousands)</i>	September 30		December 31
	2006	2005	2005
Commercial:			
Commercial, financial and industrial	\$ 6,945,207	\$ 6,354,408	\$ 6,578,117
Real estate commercial	1,199,084	1,171,606	1,213,052
Real estate construction	2,660,415	1,849,075	2,108,121
Retail:			
Real estate residential	8,417,942	7,603,249	8,357,143
Real estate construction	2,096,440	1,814,632	1,925,060
Other retail	163,134	170,684	168,413
Credit card receivables	202,866	248,049	251,016
Real estate loans pledged against other collateralized borrowings	259,232	-	-
Loans, net of unearned income	21,944,320	19,211,703	20,600,922
Allowance for loan losses	206,829	185,029	189,705
Total net loans	\$ 21,737,491	\$ 19,026,674	\$ 20,411,217

Nonperforming loans consist of impaired loans and other nonaccrual loans. An impaired loan is a loan that management believes the contractual amount due probably will not be collected. Impaired loans are generally carried on a nonaccrual status. Nonaccrual loans are loans on which interest accruals have been discontinued due to the borrower's financial difficulties. Management may elect to continue the accrual of interest when the estimated net realizable value of collateral is sufficient to recover the principal balance and accrued interest. The following table presents information concerning nonperforming loans:

<i>(Dollars in thousands)</i>	September 30		December 31
	2006	2005	2005
Impaired loans	\$ 60,372	\$ 34,243	\$ 36,635
Other nonaccrual loans*	14,072	16,861	15,624
Total nonperforming loans	\$ 74,444	\$ 51,104	\$ 52,259

\*On September 30, 2006 and 2005, and on December 31, 2005, other nonaccrual loans included \$10.5 million, \$11.9 million, and \$11.5 million, respectively, of loans held for sale.

On September 30, 2006, \$3.7 billion of real estate residential qualifying loans were pledged to secure potential Federal Home Loan Bank borrowings. Qualifying loans are comprised of residential mortgage loans secured by first and second liens and home equity lines of credit. In addition, \$5.0 billion of commercial, financial and industrial loans were pledged to secure potential discount window borrowings from the Federal Reserve Bank.

Generally, interest payments received on impaired loans are applied to principal. Once all principal has been received, additional payments are recognized as interest income on a cash basis. The following table presents information concerning impaired loans:

<i>(Dollars in thousands)</i>	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2006	2005	2006	2005
Total interest on impaired loans	\$ 538	\$ 454	\$ 882	\$ 910
Average balance of impaired loans	54,227	34,353	48,945	35,686

An allowance for loan losses is maintained for all impaired loans. Activity in the allowance for loan losses related to non-impaired loans, impaired loans, and for the total allowance for the nine months ended September 30, 2006 and 2005, is summarized as follows:

<i>(Dollars in thousands)</i>	Non-impaired	Impaired	Total
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Balance on December 31, 2004	\$ 147,672	\$ 10,487	\$ 158,159
Provision for loan losses	48,435	3,068	51,503
Acquisition	1,902	-	1,902
Charge-offs	(30,265)	(7,299)	(37,564)
Recoveries	7,919	3,110	11,029
Net charge-offs	(22,346)	(4,189)	(26,535)
Balance on September 30, 2005	\$ 175,663	\$ 9,366	\$ 185,029
Balance on December 31, 2005	\$ 179,635	\$ 10,070	\$ 189,705
Provision for loan losses	35,255	24,891	60,146
Adjustment due to divestiture	(1,470)	-	(1,470)
Charge-offs	(29,414)	(22,677)	(52,091)
Recoveries	7,687	2,852	10,539
Net charge-offs	(21,727)	(19,825)	(41,552)
<b>Balance on September 30, 2006</b>	<b>\$ 191,693</b>	<b>\$ 15,136</b>	<b>\$ 206,829</b>

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#### Note 4 - Mortgage Servicing Rights

On January 1, 2006, FHN elected early adoption of SFAS No. 156, which requires servicing rights be initially measured at fair value. Subsequently, companies are permitted to elect, on a class-by-class basis, either fair value or amortized cost accounting for their servicing rights. Accordingly, FHN began initially recognizing all its classes of mortgage servicing rights (MSR) at fair value and elected to irrevocably continue application of fair value accounting to all its classes of MSR. Classes of MSR are determined in accordance with FHN's risk management practices and market inputs used in determining the fair value of the servicing asset. FHN recognized the cumulative effect of a change in accounting principle totaling \$.2 million, net of tax, representing the excess of the fair value of the servicing asset over the recorded value on January 1, 2006. The balance of MSR included on the Consolidated Condensed Statements of Condition represents the rights to service approximately \$100.9 billion of mortgage loans on September 30, 2006, for which a servicing right has been capitalized. Following is a summary of changes in capitalized MSR as of September 30, 2006:

<i>(Dollars in thousands)</i>	First Liens	Second Liens	HELOC
Fair value on January 1, 2006	\$ 1,318,219	\$ 5,470	\$ 14,384
Addition of mortgage servicing rights	303,791	15,532	5,421
Reductions due to loan payments	(191,239)	(2,924)	(6,143)
Changes in fair value due to:			
Changes in current market interest rates	33,536	34	1,090
Changes in assumptions	-	722	8
Other changes in fair value	53	17	370
<b>Fair value on September 30, 2006</b>	<b>\$ 1,464,360</b>	<b>\$ 18,851</b>	<b>\$ 15,130</b>

In 2005 these amounts were included at the lower of cost, net of accumulated amortization, or fair value. The cost basis of MSR qualifying for SFAS No. 133 fair value hedge accounting was adjusted to reflect changes in fair value. MSR were amortized over the period of and in proportion to the estimated net servicing revenues. MSR were periodically evaluated for impairment. Impairment occurred when the current fair value of the servicing right was less than its recorded value. A quarterly value impairment analysis was performed using a discounted cash flow analysis which was disaggregated by strata representing predominant risk characteristics, including fixed and adjustable rate loans. Impairment, if any, was recognized through a valuation allowance for individual strata. However, if the impairment was determined to be other than temporary, a direct write-off of the asset was made. With the adoption of



SFAS No. 156, MSR are valued at fair value, both initially and prospectively; impairment tests are no longer performed. Following is a summary of changes in capitalized MSR as of September 30, 2005:

*(Dollars in thousands)*

Balance on December 31, 2004	\$ 1,036,458
Addition of mortgage servicing rights	314,737
Amortization	(144,492)
Market value adjustments	37,452
Permanent impairment	(36,613)
Decrease in valuation allowance	2,742
Balance on September 30, 2005	\$ 1,210,284

MSR on September 30, 2005, had an estimated market value of approximately \$1,229.5 million. This balance represents the rights to service approximately \$91.3 billion of mortgage loans on September 30, 2005, for which a servicing right was capitalized. On September 30, 2005, valuation allowances due to temporary impairment of \$1.5 million were required. Following is a summary of changes in the valuation allowance for the nine months ended September 30, 2005:

*(Dollars in thousands)*

Balance on December 31, 2004	\$ 4,231
Permanent impairment	(36,613)
Servicing valuation provision	33,871
Balance on September 30, 2005	\$ 1,489

Since sales of MSR tend to occur in private transactions and the precise terms and conditions of the sales are typically not readily available, there is a limited market to refer to in determining the fair value of MSR. As such, like other participants in the mortgage banking business,

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#### **Note 4 - Mortgage Servicing Rights (continued)**

FHN relies primarily on a discounted cash flow model to estimate the fair value of its MSR. This model calculates estimated fair value of the MSR using predominant risk characteristics of MSR, such as interest rates, type of product (fixed vs. variable), age (new, seasoned, or moderate), agency type and other factors. FHN uses assumptions in the model that it believes are comparable to those used by brokers and other service providers. FHN also periodically compares its estimates of fair value and assumptions with brokers, service providers, and recent market activity and against its own experience.

The sensitivity of the current fair value of all retained or purchased interests for MSR to immediate 10 percent and 20 percent adverse changes in assumptions on September 30, 2006, are as follows:

*(Dollars in thousands)*

*except for annual cost to service)*

#### **September 30, 2006**

	First Liens	Second Liens	HELOC
Fair value of retained interests	\$ 1,464,360	\$ 18,851	\$ 15,130
Weighted average life (in years)	6.5	2.9	2.0
Annual prepayment rate	12.1%	29.1%	49.0%
Impact on fair value of 10% adverse change	\$ (57,861)	\$ (902)	\$ (877)
Impact on fair value of 20% adverse change	(111,370)	(1,691)	(1,673)

Annual discount rate on servicing cash flows	10.2%	14.0%	18.0%
Impact on fair value of 10% adverse change	\$ (58,443)	\$ (396)	\$ (367)
Impact on fair value of 20% adverse change	(112,447)	(794)	(714)
Annual cost to service (per loan)*	\$ 55	\$ 50	\$ 50
Impact on fair value of 10% adverse change	(13,272)	(290)	(229)
Impact on fair value of 20% adverse change	(26,543)	(581)	(457)
Annual earnings on escrow	4.4%	5.2%	5.3%
Impact on fair value of 10% adverse change	\$ (35,522)	\$ (647)	\$ (609)
Impact on fair value of 20% adverse change	(71,123)	(1,306)	(1,229)

\*The annual cost to service includes an incremental cost to service delinquent loans. Historically, this fair value sensitivity disclosure has not included this incremental cost. The annual cost to service loans without the incremental cost to service delinquent loans was \$49 as of September 30, 2006.

FHN uses assumptions and estimates in determining the fair value allocated to retained interests at the time of initial securitization or sale. The key economic assumptions used to measure the fair value of the MSR at the date of securitization or loan sale were as follows for the nine months ended September 30, 2006:

	First Liens	Second Liens	HELOC
<b>Nine Months Ended September 30, 2006</b>			
Weighted average life (in years)	5.7-7.8	2.7-2.9	1.7-2.0
Annual prepayment rate	10.6%-16.3%	25%-35%	45%-55%
Annual discount rate	9.4%-11.4%	14%	18%
Annual cost to service (per loan)*	\$56-\$58	\$50	\$50
Annual earnings on escrow	4.2%-4.9%	2.0%-5.3%	2.0%-5.3%

\*The annual cost to service includes an incremental cost to service delinquent loans. Historically, the disclosure of annual cost to service assumptions has not included this incremental cost. The range of annual cost to service loans without the incremental cost to service delinquent loans was \$48-\$50 for MSR capitalized during the nine months ended September 30, 2006.

## Note 5 - Intangible Assets

The following is a summary of intangible assets, net of accumulated amortization, included in the Consolidated Condensed Statements of Condition:

	Goodwill	Other Intangible Assets*
<i>(Dollars in thousands)</i>		
December 31, 2004	\$ 160,067	\$ 22,520
Amortization expense	-	(8,033)
Acquisitions**	122,125	62,406
September 30, 2005	\$ 282,192	\$ 76,893
December 31, 2005	\$ 281,440	\$ 76,647
Amortization expense	-	(9,002)
Acquisitions**	4,871	6,124
Divestitures	(11,777)	(3,223)

**September 30, 2006** **\$ 274,534** **\$ 70,546**

\*Represents customer lists, acquired contracts, premium on purchased deposits, covenants not to compete and assets related to the minimum pension liability.

\*\*Preliminary purchase price allocations on acquisitions are based upon estimates of fair value and are subject to change.

The gross carrying amount of other intangible assets subject to amortization is \$141.5 million on September 30, 2006, net of \$71.0 million of accumulated amortization. Estimated aggregate amortization expense for the remainder of 2006 is expected to be \$2.6 million and is expected to be \$9.8 million, \$8.2 million, \$6.6 million and \$5.9 million for the twelve-month periods of 2007, 2008, 2009, and 2010, respectively.

The following is a summary of goodwill detailed by reportable segments for the nine months ended September 30:

<i>(Dollars in thousands)</i>	Retail/			
	Commercial Banking	Mortgage Banking	Capital Markets	Total
December 31, 2004	\$ 87,208	\$ 55,214	\$ 17,645	\$ 160,067
Acquisitions*	18,747	5,957	97,421	122,125
September 30, 2005	\$ 105,955	\$ 61,171	\$ 115,066	\$ 282,192
December 31, 2005	\$ 104,781	\$ 61,593	\$ 115,066	\$ 281,440
Acquisitions*	1,272	3,599	-	4,871
Divestitures	(11,777)	-	-	(11,777)
<b>September 30, 2006</b>	<b>\$ 94,276</b>	<b>\$ 65,192</b>	<b>\$ 115,066</b>	<b>\$ 274,534</b>

\* Preliminary purchase price allocations on acquisitions are based upon estimates of fair value and are subject to change.

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## Note 6 - Long-Term Debt

The following table presents information pertaining to long-term debt (debt with original maturities greater than one year) for FHN and its subsidiaries:

<i>(Dollars in thousands)</i>	September 30 <b>2006</b>	2005	December 31 2005
<b>First Tennessee Bank National Association:</b>			
Subordinated notes (qualifies for total capital under the Risk-Based Capital guidelines):			
Matures on January 15, 2015 -- 5.05%	\$ <b>387,182</b>	\$ 396,763	\$ 392,279
Matures on May 15, 2013 -- 4.625%	<b>248,060</b>	253,925	251,135
Matures on December 1, 2008 -- 5.75%	<b>137,284</b>	137,423	136,847
Matures on April 1, 2008 -- 6.40%	<b>89,894</b>	89,824	89,841
Matures on April 1, 2016 -- 5.65%	<b>251,361</b>	-	-
Bank notes*	<b>2,409,762</b>	649,973	874,672
Extendible notes**			
Final maturity of November 17, 2010 -- 5.32% on September 30, 2006, and			
4.36% on December 31, 2005	<b>1,249,264</b>	-	1,249,110
Federal Home Loan Bank borrowings***	<b>4,127</b>	4,465	4,381
<b>First Horizon National Corporation:</b>			

Subordinated capital notes (qualifies for total capital under the Risk-Based Capital guidelines):

Matures on May 15, 2013 -- 4.50%	<b>99,268</b>	101,627	100,478
Matured on November 15, 2005 -- 6.75%	-	22,894	-

Subordinated notes:

Matures on January 6, 2027 -- 8.07%	<b>101,897</b>	101,021	99,737
Matures on April 15, 2034 -- 6.30%	<b>203,337</b>	196,930	193,878

**FT Real Estate Securities Company, Inc.**

Cumulative preferred stock (qualifies for total capital under the Risk-Based Capital guidelines):

Matures on March 31, 2031 -- 9.50%	<b>45,336</b>	45,268	45,285
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**First Horizon ABS Trust**

Other collateralized borrowings

Matures on October 25, 2034--5.48%	<b>260,416</b>	-	-
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Total	<b>\$ 5,487,188</b>	\$ 2,000,113	\$3,437,643
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\* The bank notes were issued with variable interest rates and have remaining terms of 1 to 5 years. These bank notes had weighted average interest rates of 5.48 percent and 3.80 percent on September 30, 2006 and 2005, respectively and 4.66 percent on December 31, 2005.

\*\* As of September 30, 2006, the extendible notes had a contractual maturity of October 17, 2007, but are extendible at the investors' option to the final maturity date of November 17, 2010.

\*\*\* The Federal Home Loan Bank (FHLB) borrowings were issued with fixed interest rates and have remaining terms of 3 to 23 years. These borrowings had weighted average interest rates of 3.26 percent and 3.45 percent on September 30, 2006 and 2005, respectively and 3.40 percent on December 31, 2005.

Annual principal repayment requirements as of September 30, 2006, are as follows:

*(Dollars in thousands)*

2006	\$ 200,084
2007	1,400,340
2008	606,965
2009	1,070,323
2010	140
2011 and after	2,234,595

All subordinated notes are unsecured and are subordinate to other present and future senior indebtedness. FTBNA's subordinated notes and FHN's subordinated capital notes qualify as Tier 2 capital under the risk-based capital guidelines. Prior to February 2005, FTBNA had a bank note program under which the bank was able to borrow funds from time to time at maturities of 30 days to 30 years. This bank note program was terminated in connection with the establishment of a new program. That termination did not affect any previously issued notes outstanding. In February 2005, FTBNA established a new bank note program providing additional liquidity of \$5.0 billion. This bank note program provides FTBNA with a facility under which it may continuously issue and offer short- and medium-term unsecured notes. On September 30, 2006, \$2.6 billion was available under current conditions through the bank note program.

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**Note 6 - Long-Term Debt (continued)**

In November 2005, FTBNA entered into a \$3.0 billion floating rate extendible note program. The extendible note program provides FTBNA with a facility under which it may issue and offer unsecured and unsubordinated notes with initial maturities of thirteen months and final maturities of five years. On September 30, 2006, \$1.7 billion was

available under current conditions through the extendible note program.

## Note 7 - Regulatory Capital

FHN 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 material effect on FHN's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, specific capital guidelines that involve quantitative measures of assets, liabilities and certain derivatives as calculated under regulatory accounting practices must be met. Capital amounts and classification are also subject to qualitative judgment by the regulators about components, risk weightings and other factors. Quantitative measures established by regulation to ensure capital adequacy require FHN to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets (leverage). Management believes, as of September 30, 2006, that FHN met all capital adequacy requirements to which it was subject.

The actual capital amounts and ratios of FHN and FTBNA are presented in the table below. In addition, FTBNA must also calculate its capital ratios after excluding financial subsidiaries as defined by the Gramm-Leach-Bliley Act of 1999. Based on this calculation FTBNA's Total Capital, Tier 1 Capital and Leverage ratios were 11.59 percent, 7.96 percent and 6.61 percent, respectively, on September 30, 2006, and were 11.76 percent, 8.45 percent and 6.59 percent, respectively, on September 30, 2005.

<i>(Dollars in thousands)</i>	First Horizon National Corporation		First Tennessee Bank National Association	
	Amount	Ratio	Amount	Ratio
<b>On September 30, 2006:</b>				
Actual:				
Total Capital	\$ 3,998,431	12.67%	\$ 3,806,220	12.15%
Tier 1 Capital	2,660,264	8.43	2,568,052	8.20
Leverage	2,660,264	6.80	2,568,052	6.62
For Capital Adequacy Purposes:				
Total Capital	2,525,490	≥ 8.00	2,506,314	≥ 8.00
Tier 1 Capital	1,262,745	≥ 4.00	1,253,157	≥ 4.00
Leverage	1,564,438	≥ 4.00	1,552,664	≥ 4.00
To Be Well Capitalized Under Prompt Corrective Action Provisions:				
Total Capital			3,132,893	≥ 10.00
Tier 1 Capital			1,879,736	≥ 6.00
Leverage			1,940,830	≥ 5.00
On September 30, 2005:				
Actual:				
Total Capital	\$ 3,577,691	12.68%	\$ 3,441,496	11.96%
Tier 1 Capital	2,465,195	8.74	2,429,000	8.44
Leverage	2,465,195	6.54	2,429,000	6.49
For Capital Adequacy Purposes:				
Total Capital	2,257,730	≥ 8.00	2,302,711	≥ 8.00
Tier 1 Capital	1,128,865	≥ 4.00	1,151,356	≥ 4.00

Leverage	1,506,736	≥	4.00	1,496,133	≥	4.00
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To Be Well Capitalized Under Prompt  
Corrective Action Provisions:

Total Capital				2,878,389	≥	10.00
Tier 1 Capital				1,727,034	≥	6.00
Leverage				1,870,166	≥	5.00

Certain previously reported amounts have been reclassified to agree with current presentation.

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## Note 8 - Earnings Per Share

The following table shows a reconciliation of earnings per common share to diluted earnings per common share:

	Three Months Ended September 30		Nine Months Ended September 30	
	2006	2005	2006	2005
<i>(In thousands, except per share data)</i>				
Net income from continuing operations	\$ 67,179	\$ 108,114	\$ 174,522	\$ 307,075
Income from discontinued operations, net of tax	(69)	4,830	210,580	11,703
Cumulative effect of changes in accounting principle, net of tax	-	-	1,345	-
Net income	\$ 67,110	\$ 112,944	\$ 386,447	\$ 318,778
Weighted average common shares	124,150	125,838	124,431	125,171
Effect of dilutive securities	3,373	4,086	3,531	3,964
Diluted average common shares	127,523	129,924	127,962	129,135

### Earnings per common share:

Net income from continuing operations	\$ .54	\$ .86	\$ 1.40	\$ 2.45
Income from discontinued operations, net of tax	-	.04	1.69	.10
Cumulative effect of changes in accounting principle, net of tax	-	-	.02	-
Net income	\$ .54	\$ .90	\$ 3.11	\$ 2.55

### Diluted earnings per common share:

Net income from continuing operations	\$ .53	\$ .83	\$ 1.36	\$ 2.38
Income from discontinued operations, net of tax	-	.04	1.65	.09
Cumulative effect of changes in accounting principle, net of tax	-	-	.01	-
Net income	\$ .53	\$ .87	\$ 3.02	\$ 2.47

Outstanding stock options of 6,730 and 4,379 with weighted average exercise prices of \$42.34 and \$43.03 per share for the three months ended September 30, 2006 and 2005, respectively, and of 6,174 and 3,962 with weighted average exercise prices of \$42.56 and \$43.63 per share for the nine months ended September 30, 2006 and 2005, respectively, were not included in the computation of diluted earnings per common share because such shares would have had an antidilutive effect on earnings per common share.

Certain previously reported amounts have been reclassified to agree with current presentation.

In first quarter 2006, FHN purchased four million shares of its common stock. This share repurchase program was concluded for an adjusted purchase price of \$165.1 million in second quarter 2006.

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**Note 9 - Contingencies and Other Disclosures**

**Contingencies.** Contingent liabilities arise in the ordinary course of business, including those related to litigation. Various claims and lawsuits are pending against FHN and its subsidiaries. Although FHN cannot predict the outcome of these lawsuits, after consulting with counsel, management is of the opinion that when resolved, these lawsuits will not have a material adverse effect on the consolidated financial statements of FHN.

In November 2000, a complaint was filed in state court in Jackson County, Missouri against FHN's subsidiary, First Horizon Home Loans. The case generally concerns the charging of certain loan origination fees, including fees permitted by Kansas and federal law but allegedly restricted or not permitted by Missouri law, when First Horizon Home Loans or its predecessor, McGuire Mortgage Company, made certain second-lien mortgage loans. Among other relief, plaintiffs seek a refund of fees, a repayment and forgiveness of loan interest, prejudgment interest, punitive damages, loan rescission, and attorneys' fees. In response to pre-trial motions, the court has certified a statewide class action involving approximately 4,000 loans and has made the following rulings, among others: Missouri law rather than Kansas law governs at least some of those loans made before FHN acquired McGuire Mortgage (pre-acquisition loans) and Missouri law was not complied with in certain respects as to some such loans; and, federal law governs and permits the charging of loan discount fees as to those loans made after FHN acquired McGuire (post-acquisition loans). Several important issues have not yet been finally resolved by the court, including, among others: whether Missouri or federal law generally governs the post-acquisition loan fees (other than loan discount fees); whether plaintiffs are entitled to seek recovery and forgiveness of loan interest; whether prejudgment interest is available to be awarded; and, whether the applicable statute of limitations is three or six years. Trial had been scheduled for the fourth quarter of 2006.

As a result of mediation, FHN has entered into a verbal agreement in principle to settle the McGuire lawsuit. In connection with this settlement, FHN has agreed to pay, under agreed circumstances using an agreed methodology, an aggregate of up to approximately \$36 million. FHN has recorded a pre-tax charge to earnings of approximately \$21 million in the third quarter of 2006 in connection with the settlement. The total amount currently reserved for this matter is approximately \$22 million. A written settlement agreement currently is being negotiated by the parties, and the settlement is subject to approval by the court.

The loss reserve for this matter reflects an estimate of the amount that ultimately would be paid under the settlement. The difference between the maximum amount possible under the settlement and the amount reserved reflects the company's view, among other things, of the number of purported class members that probably will participate in the settlement. The assumptions involved in estimating the actual level of participation and loss are highly judgmental and, accordingly, the ultimate amount paid under the settlement could be higher or lower than the amount reserved at present, but cannot exceed the settlement amount.

**Other disclosures - Indemnification agreements and guarantees.** In the ordinary course of business, FHN enters into indemnification agreements for legal proceedings against its directors and officers and standard representations and warranties for underwriting agreements, merger and acquisition agreements, loan sales, contractual commitments, and various other business transactions or arrangements. The extent of FHN's obligations under these agreements depends upon the occurrence of future events; therefore, it is not possible to estimate a maximum potential amount of payouts that could be required with such agreements.

First Horizon Home Loans services a mortgage loan portfolio of approximately \$100.6 billion on September 30, 2006, a significant portion of which is held by GNMA, FNMA, FHLMC or private security holders. In connection with its servicing activities, First Horizon Home Loans guarantees the receipt of the scheduled principal and interest payments on the underlying loans. In the event of customer non-performance on the loan, First Horizon Home Loans is

obligated to make the payment to the security holder. Under the terms of the servicing agreements, First Horizon Home Loans can utilize payments received from other prepaid loans in order to make the security holder whole. In the event payments are ultimately made by First Horizon Home Loans to satisfy this obligation, for loans sold with no recourse, all funds are recoverable from the government agency at foreclosure sale.

First Horizon Home Loans is also subject to losses in its loan servicing portfolio due to loan foreclosures and other recourse obligations. Certain agencies have the authority to limit their repayment guarantees on foreclosed loans resulting in certain foreclosure costs being borne by servicers. In addition, First Horizon Home Loans has exposure on all loans sold with recourse. First Horizon Home Loans has various claims for reimbursement, repurchase obligations, and/or indemnification requests outstanding with government agencies or private investors. First Horizon Home Loans has evaluated all of its exposure under recourse obligations based on factors, which include loan delinquency status, foreclosure expectancy rates and claims outstanding. Accordingly, First Horizon Home Loans had an allowance for

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### **Note 9 - Contingencies and Other Disclosures (continued)**

losses on the mortgage servicing portfolio of approximately \$14.8 million and \$16.8 million on September 30, 2006 and 2005, respectively. First Horizon Home Loans has sold certain mortgage loans with an agreement to repurchase the loans upon default. For the single-family residential loans, in the event of borrower nonperformance, First Horizon Home Loans would assume losses to the extent they exceed the value of the collateral and private mortgage insurance, FHA insurance or VA guarantees. On September 30, 2006 and 2005, First Horizon Home Loans had single-family residential loans with outstanding balances of \$130.4 million and \$165.1 million, respectively that were serviced on a full recourse basis. On September 30, 2006 and 2005, the outstanding principal balance of loans sold with limited recourse arrangements where some portion of the principal is at risk and serviced by First Horizon Home Loans was \$3.0 billion and \$3.2 billion, respectively. Additionally, on September 30, 2006 and 2005, \$5.1 billion and \$6.0 billion, respectively, of mortgage loans were outstanding which were sold under limited recourse arrangements where the risk is limited to interest and servicing advances.

FHN has securitized and sold HELOC and second-lien mortgages which are held by private security holders, and on September 30, 2006, the outstanding principal balance of these loans was \$415.5 million and \$105.2 million, respectively. On September 30, 2005, the outstanding principal balance of securitized and sold HELOC and second-lien mortgages was \$777.9 million and \$161.3 million, respectively. In connection with its servicing activities, FTBNA does not guarantee the receipt of the scheduled principal and interest payments on the underlying loans but does have residual interests of \$53.3 million and \$56.5 million on September 30, 2006 and 2005, respectively, which are available to make the security holder whole in the event of credit losses. FHN has projected expected credit losses in the valuation of the residual interest.

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### **Note 10 - Pension and Other Employee Benefits**

**Pension plan.** FHN provides pension benefits to employees retiring under the provisions of a noncontributory, defined benefit pension plan. Employees of FHN's mortgage subsidiary and certain insurance subsidiaries are not covered by the pension plan. Pension benefits are based on years of service, average compensation near retirement and estimated social security benefits at age 65. The annual funding is based on an actuarially determined amount using the entry age cost method. FHN also maintains a nonqualified supplemental executive retirement plan that covers certain employees whose benefits under the pension plan have been limited under Tax Code Section 415 and Tax Code Section 401(a)(17), which limit compensation to \$220,000 for purposes of benefit calculations. Compensation is defined in the same manner as it is under the pension plan. Participants receive the difference between the monthly



pension payable, if tax code limits did not apply, and the actual pension payable. All benefits provided under this plan are unfunded and payments to plan participants are made by FHN.

**Other employee benefits.** FHN provides postretirement medical insurance to full-time employees retiring under the provisions of the FHN Pension Plan. The postretirement medical plan is contributory with retiree contributions adjusted annually. The plan is based on criteria that are a combination of the employee's age and years of service and utilizes a two-step approach. For any employee retiring on or after January 1, 1995, FHN contributes a fixed amount based on years of service and age at time of retirement. FHN's postretirement benefits include prescription drug benefits. The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) introduces a prescription drug benefit under Medicare Part D as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. FSP FAS 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003," requires a plan sponsor to determine if benefits offered through a postretirement health care plan are actuarially equivalent to Medicare Part D. Plan benefits were determined to be actuarially equivalent in 2005.

The components of net periodic benefit cost for the three months ended September 30 are as follows:

<i>(Dollars in thousands)</i>	Pension Benefits		Postretirement Benefits	
	2006	2005	2006	2005
<b>Components of net periodic benefit cost</b>				
Service cost	\$ 4,521	\$ 3,946	\$ 83	\$ 173
Interest cost	5,485	5,318	279	336
Expected return on plan assets	(8,945)	(8,124)	(421)	(417)
Amortization of prior service cost/(benefit)	211	207	(44)	(44)
Recognized losses/(gains)	1,769	1,013	(141)	(85)
Amortization of transition obligation	-	-	248	247
Net periodic cost	\$ 3,041	\$ 2,360	\$ 4	\$ 210

The components of net periodic benefit cost for the nine months ended September 30 are as follows:

<i>(Dollars in thousands)</i>	Pension Benefits		Postretirement Benefits	
	2006	2005	2006	2005
<b>Components of net periodic benefit cost</b>				
Service cost	\$ 13,561	\$ 11,836	\$ 249	\$ 571
Interest cost	16,456	15,953	837	1,211
Expected return on plan assets	(26,834)	(24,370)	(1,262)	(1,251)
Amortization of prior service cost/(benefit)	633	621	(132)	(132)
Recognized losses/(gains)	5,306	3,041	(422)	(85)
Amortization of transition obligation	-	-	742	741
Net periodic cost	\$ 9,122	\$ 7,081	\$ 12	\$ 1,055

FHN plans to make a contribution to the pension plan during the fourth quarter 2006, however is still evaluating the Pension Protection Act of 2006 to determine the optimal contribution level. FHN does not anticipate making a contribution to the postretirement benefit plan during 2006.

## Note 11 - Stock Option, Restricted Stock Incentive, and Dividend Reinvestment Plans

**Stock option plans.** FHN issues non-qualified stock options to employees under various plans, which provide for the issuance of FHN common stock at a price equal to its fair market value at the date of grant. All options vest within 3

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to 4 years and expire 7 years or 10 years from the date of grant. A deferral program, which was discontinued in 2005, allowed for the foregone compensation plus the exercise price to equal the fair market value of the stock on the date of grant if the grantee agreed to receive the options in lieu of compensation. Any options issued below market on the date of grant during 2005 were related to 2004 salary deferrals for employees and 2004 board compensation for directors. Options that were part of compensation deferral prior to January 2, 2004, expire 20 years from the date of grant. Stock options granted after January 2, 2004, that are part of the compensation deferral expire 10 years from the date of grant. There were 4,465,056 shares available for option or share grants on September 30, 2006.

The summary of stock option activity during the nine months ended September 30, 2006, is shown below:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (thousands)
January 1, 2006	20,289,455	\$ 32.87		
Options granted	1,629,771	40.71		
Options exercised*	(1,873,718)	26.81		
Options canceled	(814,966)	40.96		
<b>September 30, 2006</b>	<b>19,230,542</b>	<b>33.79</b>	<b>6.66</b>	<b>\$ 111,768</b>
Options exercisable	13,087,565	\$ 30.00	7.21	\$ 111,519
Options expected to vest	4,484,313	41.86	5.49	212

\* Stock options exercised for nine months ended September 30, 2006 included 1,242 options converted to stock equivalents as part of the deferred compensation program.

The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005, was \$26.0 million and \$24.7 million, respectively. As of September 30, 2006, there was \$15.1 million of unrecognized compensation cost related to nonvested stock options. That cost is expected to be recognized over a weighted-average period of 1.10 years. The following data summarizes information about stock options granted during the nine months ended September 30:

	Number Granted	Weighted Average Fair Value per Option at Grant Date
<b>2006:</b>		
Options granted	<b>1,629,771</b>	<b>\$ 5.91</b>
2005:		
Options granted	2,396,261	\$ 6.90

FHN used the Black-Scholes Option Pricing Model to estimate the fair value of stock options granted in the nine months ended September 30, 2006 and 2005, with the following assumptions:

	Nine months ended September 30	
	2006	2005
Expected dividend yield	<b>4.42%</b>	4.25%
Expected lives of options granted	<b>5.26 years</b>	5.11 years
Expected volatility	<b>19.00%</b>	22.84%
Risk-free interest rates	<b>4.92%</b>	3.89%

**Note 11 - Stock Option, Restricted Stock Incentive, and Dividend Reinvestment Plans (continued)**

Expected lives of options granted are determined based on the vesting period, historical exercise patterns and contractual term of the options. Expected volatility is estimated using average of daily high and low stock prices, excluding swings in volatility caused by unique, infrequent circumstances. Expected volatility assumptions are determined over the period of the expected lives of the options.

**Restricted stock incentive plans.** FHN has authorized the issuance of its common stock for awards to executive and other management employees who have a significant impact on the profitability of FHN. Under a performance accelerated restricted stock program, restricted shares can vest as early as 3 years instead of 10 years following the grant date if predetermined performance criteria are met. Under the long-term incentive program, performance stock units vest only if predetermined performance measures are met. Units are forfeited if the performance criteria are not met. In 2006, restricted stock and stock options were awarded to the Chief Executive Officer and Chief Operating Officer, which will vest over 3 and 4 years, but only if predetermined performance measures are met. FHN also grants restricted stock awards to all management employees, which typically vest over 3 and 4 years. Additionally, one of the plans allows stock awards to be granted to non-employee directors upon approval by the board of directors. It has been the recent practice of the board to grant 8,000 shares of restricted stock to each new non-employee director upon election to the board, with restrictions lapsing at a rate of ten percent per year. Beginning in 2007, this practice will be discontinued, all outstanding director shares vesting after 2007 will be canceled and each director will receive an annual grant of restricted stock units valued at approximately \$45,000. The summary of restricted stock activity during the nine months ended September 30, 2006, is presented below:

	Shares/ Units	Weighted average grant date fair value
Nonvested on January 1, 2006	1,228,282	\$ 41.10
Shares/units granted	682,010	40.20
Shares/units vested	(44,167)	35.20
Shares/units canceled	(163,364)	41.47
<b>Nonvested on September 30, 2006</b>	<b>1,702,761</b>	<b>\$ 40.86</b>

As of September 30, 2006, there was \$20.1 million of unrecognized compensation cost related to nonvested restricted stock plans. That cost is expected to be recognized over a weighted-average period of 3.16 years. The total grant date fair value of shares vested during the nine months ended September 30, 2006 and 2005, was \$1.6 million and \$2.0 million, respectively.

The board of directors approved amendments to the restricted stock plan during 1998 permitting deferral by participants of the receipt of restricted stock prior to the lapse of restrictions. Due to deferred compensation legislation passed in 2004, participants are no longer allowed to make voluntary deferral elections under the stock programs.

The compensation cost that has been included in income from continuing operations pertaining to both stock option and restricted stock plans was \$9.7 million and \$20.9 million for the nine months ended September 30, 2006 and 2005, respectively. The corresponding total income tax benefits recognized in the income statements were \$3.7 million and \$7.8 million for the nine months ended September 30, 2006 and 2005, respectively.

Consistent with Tennessee state law, only new or authorized, but unissued, shares may be utilized in connection with any issuance of FHN common stock which may be required as a result of share based compensation awards. FHN historically obtains authorization from the Board of Directors to repurchase any shares that may be issued at the time a plan is approved or amended. Repurchases are authorized to be made in the open market or through privately

negotiated transactions and will be subject to market conditions, accumulation of excess equity, and prudent capital management. FHN does not currently expect to repurchase a material number of shares related to the plans during the next annual period.

**Dividend reinvestment plan.** The Dividend Reinvestment and Stock Purchase Plan (the Plan) authorizes the sale of FHN's common stock from shares acquired on the open market to shareholders who choose to invest all or a portion of their cash dividends and make optional cash payments of \$25 to \$10,000 per quarter without paying commissions. The price of shares purchased on the open market is the average price paid.

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## Note 12 - Business Segment Information

FHN has four business segments, Retail/Commercial Banking, Mortgage Banking, Capital Markets and Corporate. The Retail/Commercial Banking segment offers financial products and services, including traditional lending and deposit taking, to retail and commercial customers. Additionally, Retail/Commercial Banking provides investments, insurance, financial planning, trust services and asset management, credit card, cash management, check clearing, and correspondent services. On March 1, 2006, FHN sold its national merchant processing business. The divestiture was accounted for as a discontinued operation which is included in the Retail/Commercial Banking segment. The Mortgage Banking segment consists of core mortgage banking elements including originations and servicing and the associated ancillary revenues related to these businesses. The Capital Markets segment consists of traditional capital markets securities activities, structured finance, equity research, investment banking, loan sales, portfolio advisory, and the sale of bank-owned life insurance. The Corporate segment consists of unallocated corporate expenses, expense on subordinated debt issuances and preferred stock, bank-owned life insurance, unallocated interest income associated with excess equity, net impact of raising incremental capital, funds management and venture capital. Periodically, FHN adapts its segments to reflect changes in expense allocations between segments. Previously reported amounts are reclassified to agree with current presentation. Effective January 1, 2006, FHN adopted SFAS No. 123-R and retroactively applied the provisions of the standard. Accordingly, results for prior periods have been adjusted to reflect expensing of share-based compensation.

Total revenue, expense and asset levels reflect those which are specifically identifiable or which are allocated based on an internal allocation method. Because the allocations are based on internally developed assignments and allocations, they are to an extent subjective. This assignment and allocation has been consistently applied for all periods presented. The following table reflects the amounts of consolidated revenue, expense, tax, and assets for each segment for the three and nine months ending September 30:

<i>(Dollars in thousands)</i>	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2006	2005	2006	2005
<b>Total Consolidated</b>				
Net interest income	\$ 251,621	\$ 260,160	\$ 750,940	\$ 729,215
Provision for loan losses	23,694	22,608	60,146	51,503
Noninterest income	321,385	346,599	859,116	989,590
Noninterest expense	456,357	426,175	1,319,558	1,216,934
Pre-tax Income	92,955	157,976	230,352	450,368
Provision for income taxes	25,776	49,862	55,830	143,293
Income from continuing operations	67,179	108,114	174,522	307,075
(Loss)/income from discontinued operations, net of tax	(69)	4,830	210,580	11,703
Income before cumulative effect	67,110	112,944	385,102	318,778
Cumulative effect of changes in				

accounting principle, net of tax	-	-	1,345	-
Net income	\$ 67,110	\$ 112,944	\$ 386,447	\$ 318,778
Average assets	\$ 39,519,765	\$ 38,090,993	\$ 38,574,766	\$ 36,169,529

**Retail/Commercial Banking**

Net interest income	\$ 231,967	\$ 224,895	\$ 687,548	\$ 634,842
Provision for loan losses	23,550	22,428	59,937	51,164
Noninterest income	110,429	106,564	328,749	307,253
Noninterest expense	204,109	199,653	631,537	572,141
Pre-tax income	114,737	109,378	324,823	318,790
Provision for income taxes	35,207	33,008	92,294	97,894
Income from continuing operations	79,530	76,370	232,529	220,896
(Loss)/income from discontinued operations, net of tax	(69)	4,830	210,580	11,703
Income before cumulative effect	79,461	81,200	443,109	232,599
Cumulative effect of changes in accounting principle, net of tax	-	-	522	-
Net income	\$ 79,461	\$ 81,200	\$ 443,631	\$ 232,599
Average assets	\$ 23,469,885	\$ 22,385,176	\$ 23,220,759	\$ 21,052,337

Certain previously reported amounts have been reclassified to agree with current presentation.

**Note 12 - Business Segment Information (continued)**

<i>(Dollars in thousands)</i>	Three Months Ended September 30		Nine Months Ended September 30	
	2006	2005	2006	2005
<b>Mortgage Banking</b>				
Net interest income	\$ 20,866	\$ 41,769	\$ 71,333	\$ 112,903
Provision for loan losses	144	180	209	339
Noninterest income	97,323	151,254	306,047	391,569
Noninterest expense	143,601	132,253	378,881	355,737
Pre-tax (loss)/income	(25,556)	60,590	(1,710)	148,396
(Benefit)/provision for income taxes	(10,554)	21,881	(2,626)	53,346
(Loss)/income before cumulative effect	(15,002)	38,709	916	95,050
Cumulative effect of changes in accounting principle, net of tax	-	-	414	-
Net (loss)/income	\$ (15,002)	\$ 38,709	\$ 1,330	\$ 95,050
Average assets	\$ 6,345,865	\$ 6,882,405	\$ 6,395,532	\$ 6,285,889
<b>Capital Markets</b>				
Net interest expense	\$ (1,493)	\$ (7,744)	\$ (11,585)	\$ (22,381)
Noninterest income	101,602	86,241	301,498	282,886
Noninterest expense	86,276	76,093	253,208	240,663
Pre-tax income	13,833	2,404	36,705	19,842
Provision for income taxes	4,240	481	13,008	6,691
Income before cumulative effect	9,593	1,923	23,697	13,151
Cumulative effect of changes in accounting principle, net of tax	-	-	179	-
Net income	\$ 9,593	\$ 1,923	\$ 23,876	\$ 13,151

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Average assets	\$	<b>5,290,045</b>	\$	5,418,516	\$	<b>5,116,689</b>	\$	5,489,764
<b>Corporate</b>								
Net interest income	\$	<b>281</b>	\$	1,240	\$	<b>3,644</b>	\$	3,851
Noninterest income/(expense)		<b>12,031</b>		2,540		<b>(77,178)</b>		7,882
Noninterest expense		<b>22,371</b>		18,176		<b>55,932</b>		48,393
Pre-tax loss		<b>(10,059)</b>		(14,396)		<b>(129,466)</b>		(36,660)
Income tax benefit		<b>(3,117)</b>		(5,508)		<b>(46,846)</b>		(14,638)
Loss before cumulative effect		<b>(6,942)</b>		(8,888)		<b>(82,620)</b>		(22,022)
Cumulative effect of changes in accounting principle, net of tax		-		-		<b>230</b>		-
Net loss	\$	<b>(6,942)</b>	\$	(8,888)	\$	<b>(82,390)</b>	\$	(22,022)
Average assets	\$	<b>4,413,970</b>	\$	3,404,896	\$	<b>3,841,786</b>	\$	3,341,539

Certain previously reported amounts have been reclassified to agree with current presentation.

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### Note 13 - Derivatives

In the normal course of business, FHN utilizes various financial instruments, through its mortgage banking, capital markets and risk management operations, which include derivative contracts and credit-related arrangements, as part of its risk management strategy and as a means to meet customers' needs. These instruments are subject to credit and market risks in excess of the amount recorded on the balance sheet in accordance with generally accepted accounting principles. The contractual or notional amounts of these financial instruments do not necessarily represent credit or market risk. However, they can be used to measure the extent of involvement in various types of financial instruments. Controls and monitoring procedures for these instruments have been established and are routinely reevaluated. The Asset/Liability Committee (ALCO) monitors the usage and effectiveness of these financial instruments.

Credit risk represents the potential loss that may occur because a party to a transaction fails to perform according to the terms of the contract. The measure of credit exposure is the replacement cost of contracts with a positive fair value. FHN manages credit risk by entering into financial instrument transactions through national exchanges, primary dealers or approved counterparties, and using mutual margining agreements whenever possible to limit potential exposure. With exchange-traded contracts, the credit risk is limited to the clearinghouse used. For non-exchange traded instruments, credit risk may occur when there is a gain in the fair value of the financial instrument and the counterparty fails to perform according to the terms of the contract and/or when the collateral proves to be of insufficient value. Market risk represents the potential loss due to the decrease in the value of a financial instrument caused primarily by changes in interest rates, mortgage loan prepayment speeds or the prices of debt instruments. FHN manages market risk by establishing and monitoring limits on the types and degree of risk that may be undertaken. FHN continually measures this risk through the use of models that measure value-at-risk and earnings-at-risk.

**Derivative Instruments.** FHN enters into various derivative contracts both in a dealer capacity, to facilitate customer transactions, and also as a risk management tool. Where contracts have been created for customers, FHN enters into transactions with dealers to offset its risk exposure. Derivatives are also used as a risk management tool to hedge FHN's exposure to changes in interest rates or other defined market risks.

Derivative instruments are recorded on the Consolidated Condensed Statements of Condition as other assets or other liabilities measured at fair value. Fair value is defined as the amount FHN would receive or pay in the market to replace the derivatives as of the valuation date. Fair value is determined using available market information and appropriate valuation methodologies. For a fair value hedge, changes in the fair value of the derivative instrument and changes in the fair value of the hedged asset or liability are recognized currently in earnings. For a cash flow hedge,

changes in the fair value of the derivative instrument, to the extent that it is effective, are recorded in accumulated other comprehensive income and subsequently reclassified to earnings as the hedged transaction impacts net income. Any ineffective portion of a cash flow hedge is recognized currently in earnings. For free-standing derivative instruments, changes in fair value are recognized currently in earnings. Cash flows from derivative contracts are reported as operating activities on the Consolidated Condensed Statements of Cash Flows.

Interest rate forward contracts are over-the-counter contracts where two parties agree to purchase and sell a specific quantity of a financial instrument at a specified price, with delivery or settlement at a specified date. Futures contracts are exchange-traded contracts where two parties agree to purchase and sell a specific quantity of a financial instrument at a specific price, with delivery or settlement at a specified date. Interest rate option contracts give the purchaser the right, but not the obligation, to buy or sell a specified quantity of a financial instrument, at a specified price, during a specified period of time. Caps and floors are options that are linked to a notional principal amount and an underlying indexed interest rate. Interest rate swaps involve the exchange of interest payments at specified intervals between two parties without the exchange of any underlying principal. Swaptions are options on interest rate swaps that give the purchaser the right, but not the obligation, to enter into an interest rate swap agreement during a specified period of time.

### Mortgage Banking

Mortgage banking interest rate lock commitments are short-term commitments to fund mortgage loan applications in process (the pipeline) for a fixed term at a fixed price. During the term of an interest rate lock commitment, First Horizon Home Loans has the risk that interest rates will change from the rate quoted to the borrower. First Horizon Home Loans enters into forward sales contracts with respect to fixed rate loan commitments and futures contracts with respect to adjustable rate loan commitments as economic hedges designed to protect the value of the interest rate lock commitments from changes in value due to changes in interest rates. Under SFAS No. 133 interest rate lock commitments qualify as derivative financial instruments and as such do not qualify for hedge accounting treatment. As a result, the interest rate lock commitments are recorded at fair value with changes in fair value recorded in current earnings as gain or loss on the sale of loans in mortgage banking noninterest income. Changes in the fair value of the derivatives that serve as economic hedges of interest rate lock

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### **Note 13 - Derivatives (continued)**

commitments are also included in current earnings as a component of gain or loss on the sale of loans in mortgage banking noninterest income.

First Horizon Home Loans' warehouse (mortgage loans held for sale) is subject to changes in fair value, primarily due to fluctuations in interest rates from the loan closing date through the date of sale of the loan into the secondary market. Typically, the fair value of the warehouse declines in value when interest rates increase and rises in value when interest rates decrease. To mitigate this risk, First Horizon Home Loans enters into forward sales contracts and futures contracts to provide an economic hedge against those changes in fair value on a significant portion of the warehouse. These derivatives are recorded at fair value with changes in fair value recorded in current earnings as a component of the gain or loss on the sale of loans in mortgage banking noninterest income.

To the extent that these interest rate derivatives are designated to hedge specific similar assets in the warehouse and prospective analyses indicate that high correlation is expected, the hedged loans are considered for hedge accounting under SFAS No. 133. Anticipated correlation is determined based on historical regressions between the change in fair value of the derivatives and the change in fair value of hedged mortgage loans. Beginning in fourth quarter 2005, anticipated correlation is determined by projecting a dollar offset relationship for each tranche based on anticipated changes in the fair value of the hedged mortgage loans and the related derivatives, in response to various interest rate

shock scenarios. Hedges are reset daily and the statistical correlation is calculated using these daily data points. Retrospective hedge effectiveness is measured using the regression correlation results. First Horizon Home Loans generally maintains a coverage ratio (the ratio of expected change in the fair value of derivatives to expected change in the fair value of hedged assets) of approximately 100 percent on warehouse loans hedged under SFAS No. 133. Effective SFAS No. 133 hedging results in adjustments to the recorded value of the hedged loans. These basis adjustments, as well as the change in fair value of derivatives attributable to effective hedging, are included as a component of the gain or loss on the sale of loans in mortgage banking noninterest income.

Warehouse loans qualifying for SFAS No. 133 hedge accounting treatment totaled \$1.0 billion and \$.5 billion on September 30, 2006 and 2005, respectively. The balance sheet impacts of the related derivatives were net liabilities of \$5.7 million on September 30, 2006, and net assets of \$2.1 million on September 30, 2005.

First Horizon Home Loans also enters into hedges of the MSR to minimize the effects of loss in value of MSR associated with increased prepayment activity that generally results from declining interest rates. In a rising interest rate environment, the value of the MSR generally will increase while the value of the hedge instruments will decline.

First Horizon Home Loans enters into interest rate contracts (including swaps, swaptions, and mortgage forward sales contracts) to hedge against the effects of changes in fair value of its MSR. Substantially all capitalized MSR are hedged for economic purposes.

Prior to the adoption of SFAS No. 156, First Horizon Home Loans hedged the changes in MSR value attributable to changes in the benchmark interest rate (10-year LIBOR swap rate). The vast majority of MSR routinely qualified for hedge accounting. For purposes of measuring effectiveness of the hedge, time decay and recognized net interest income, including changes in value attributable to changes in spot and forward prices, if applicable, were excluded from the change in value of the related derivatives. Interest rate derivative contracts used to hedge against interest rate risk in the servicing portfolio were designated to specific risk tranches of servicing. Hedges were reset at least monthly and more frequently, as needed, to respond to changes in interest rates or hedge composition. Generally, a coverage ratio approximating 100 percent was maintained on hedged MSR. Prior to acquiring a new hedge instrument, First Horizon Home Loans performed a prospective evaluation of anticipated hedge effectiveness by reviewing the historical regression between the underlying index of the proposed hedge instrument and the mortgage rate. At the end of each hedge period, the change in the fair value of the hedged MSR asset due to the change in benchmark interest rate was calculated and became a historical data point. Retrospective hedge effectiveness was determined by performing a regression analysis of all collected data points over a rolling 12-month period. Effective hedging under SFAS No. 133 resulted in adjustments to the recorded value of the MSR. These basis adjustments, as well as the change in fair value of derivatives attributable to effective hedging, were included as a component of servicing income in mortgage banking noninterest income. MSR subject to SFAS No. 133 hedges totaled \$1.2 billion on September 30, 2005. The balance sheet impact of the related derivatives was a net asset of \$4.5 million on September 30, 2005. The following table summarizes certain information related to mortgage banking hedging activities for the three and nine month periods ended September 30:

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**Note 13 - Derivatives (continued)**

<i>(Dollars in thousands)</i>	Three Months Ended		Nine Months Ended	
	September 30 2006	2005	September 30 2006	2005
<b>Warehouse loans</b>				
Fair value hedge ineffectiveness net (losses)/gains	\$ (1,013)	\$ 422	\$ (11,404)	\$ 1,997
<b>Mortgage servicing rights</b>				
Fair value hedge ineffectiveness net losses	N/A**	(8,236)	N/A**	(2,534)
Net losses excluded from assessment of effectiveness*	N/A**	(5,218)	N/A**	(1,126)



\* Represents the derivative gain from net interest income on swaps, net of time decay.

\*\* Due to adoption of SFAS No. 156, MSR are no longer hedged under SFAS No. 133. First Horizon Home Loans continues to enter into interest rate contracts to provide an economic hedge against changes in fair value of MSR.

In 2005, First Horizon Home Loans used different MSR stratification for purposes of determining hedge effectiveness pursuant to SFAS No. 133 and performing impairment testing pursuant to SFAS No. 140. The hedge results were evaluated under SFAS No. 133 using specific risk tranches that were established for hedging purposes. For risk tranches that were successfully hedged pursuant to SFAS No. 133, the MSR basis adjustments were allocated to small pools of loans within the risk tranches. These pools of loans were then aggregated into the less granular SFAS No. 140 strata. This adjusted MSR carrying value was then compared to the fair value of the MSR for each stratum to test for asset impairment. MSR basis was reduced to the extent that carrying value exceeds fair value. Any reduction in carrying value as a result of this impairment test was included as a component of servicing income in mortgage banking noninterest income. In 2006, First Horizon revalues MSR to current fair value each month. Changes in fair value are included in servicing income in mortgage banking noninterest income.

First Horizon Home Loans utilizes derivatives (including swaps, swaptions, and mortgage forward sales contracts) that change in value inversely to the movement of interest rates to protect the value of its interest-only securities as an economic hedge. Changes in the fair value of these derivatives are recognized currently in earnings in mortgage banking noninterest income as a component of servicing income. Interest-only securities are included in trading securities with changes in fair value recognized currently in earnings in mortgage banking noninterest income as a component of servicing income.

#### Capital Markets

Capital Markets trades U.S. Treasury, U.S. Agency, mortgage-backed, corporate and municipal fixed income securities and other securities for distribution to customers. When these securities settle on a delayed basis, they are considered forward contracts. Capital Markets also enters into interest rate contracts, including options, caps, swaps, futures and floors for its customers. In addition, Capital Markets enters into futures contracts to economically hedge interest rate risk associated with its securities inventory. These transactions are measured at fair value, with changes in fair value recognized currently in capital markets noninterest income. Related assets and liabilities are recorded on the balance sheet as other assets and other liabilities. Credit risk related to these transactions is controlled through credit approvals, risk control limits and ongoing monitoring procedures through the Senior Credit Policy Committee.

In fourth quarter 2005, Capital Markets utilized a forward contract as a cash flow hedge of the risk of change in the fair value of a forecasted sale of certain loans. In 2006, \$77 thousand of net losses which were recorded in other comprehensive income on December 31, 2005, were recognized in earnings. The amount of SFAS No. 133 hedge ineffectiveness related to this cash flow hedge was immaterial.

#### Interest Rate Risk Management

FHN's ALCO focuses on managing market risk by controlling and limiting earnings volatility attributable to changes in interest rates. Interest rate risk exists to the extent that interest-earning assets and liabilities have different maturity or repricing characteristics. FHN uses derivatives, including swaps, caps, options, and collars, that are designed to moderate the impact on earnings as interest rates change. FHN's interest rate risk management policy is to use derivatives not to speculate but to hedge interest rate risk or market value of assets or liabilities. In addition, FHN has entered into certain interest rate swaps and caps as a part of a product offering to commercial customers with customer derivatives paired with offsetting market instruments that, when completed, are designed to eliminate market risk. These

**Note 13 - Derivatives (continued)**

contracts do not qualify for hedge accounting and are measured at fair value with gains or losses included in current earnings in noninterest income.

FHN has entered into pay floating, receive fixed interest rate swaps to hedge the interest rate risk of certain large institutional certificates of deposit, totaling \$61.4 million and \$211.1 million on September 30, 2006 and 2005, respectively. These swaps have been accounted for as fair value hedges under the shortcut method. The balance sheet impact of these swaps was a liability of \$1.1 million and \$1.4 million on September 30, 2006 and 2005, respectively. Interest paid or received for these swaps was recognized as an adjustment of the interest expense of the liabilities whose risk is being managed.

FHN has entered into pay floating, receive fixed interest rate swaps to hedge the interest rate risk of certain long-term debt obligations, totaling \$1.1 billion and \$.9 billion on September 30, 2006 and 2005, respectively. These swaps have been accounted for as fair value hedges under the shortcut method. The balance sheet impact of these swaps was \$2.0 million in other assets and \$19.0 million in other liabilities on September 30, 2006, and was \$5.6 million in other assets and \$6.4 million in other liabilities on September 30, 2005. Interest paid or received for these swaps was recognized as an adjustment of the interest expense of the liabilities whose risk is being managed.

FHN has determined that derivative transactions used in hedging strategies to manage interest rate risk on subordinated debt related to its trust preferred securities did not qualify for hedge accounting under the shortcut method. As a result, any fluctuations in the market value of the derivatives should have been recorded through the income statement with no corresponding offset to the hedged item. While management believes these hedges would have qualified for hedge accounting under the long haul method, that accounting cannot be applied retroactively. FHN evaluated the impact to all quarterly and annual periods since the inception of the hedges and concluded that the impact was immaterial in each period. In first quarter 2006, FHN recorded an adjustment to recognize the cumulative impact of these transactions that resulted in a negative \$15.6 million impact to noninterest income, which was included in current earnings. FHN has subsequently redesignated these hedge relationships under SFAS No. 133 using the long haul method. For the period of time during first quarter 2006 that these hedge relationships were not redesignated under SFAS No. 133, the swaps were measured at fair value with gains or losses included in current earnings. FHN has entered into pay floating, receive fixed interest rate swaps to hedge the interest rate risk of certain subordinated debt. The balance sheet impact of these swaps was \$20.4 million and \$11.3 million in other liabilities on September 30, 2006 and 2005, respectively. There was no ineffectiveness related to these swaps.

In first quarter 2006, FHN utilized an interest rate swap as a cash flow hedge of the interest payment on a floating-rate bank note with a fair value of \$100.6 million on September 30, 2006, and a maturity in first quarter 2009. The balance sheet impact of this swap was \$.6 million in other assets and \$.4 million net of tax, in other comprehensive income. There was no ineffectiveness related to this swap.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**GENERAL INFORMATION**

FHN is a national financial services institution. From a small community bank chartered in 1864, FHN has grown to be one of the 30 largest bank holding companies in the United States in terms of asset size.

Over 12,000 employees provide a broad array of financial services to individual and business customers through hundreds of offices located in 46 states.

AARP, Working Mother and Fortune magazine have recognized FHN companies as some of the nation's best employers. FHN also was named one of the nation's 100 best corporate citizens by Business Ethics magazine.

FHN provides a broad array of financial services to its customers through three national businesses. The combined strengths of these businesses create an extensive range of financial products and services. In addition, the corporate segment provides essential support within the corporation.

§ Retail/Commercial Banking offers financial products and services, including traditional lending and deposit-taking, to retail and commercial customers. Additionally, the retail/commercial bank provides investments, insurance, financial planning, trust services and asset management, credit card, cash management, check clearing, and correspondent services. On March 1, 2006, FHN sold its national merchant processing business. The divestiture was accounted for as a discontinued operation which is included in the Retail/Commercial Banking segment.

§ Mortgage Banking helps provide home ownership through First Horizon Home Loans, which operates offices in 44 states and is one of the top 15 mortgage servicers and top 25 originators of mortgage loans to consumers. This segment consists of core mortgage banking elements including originations and servicing and the associated ancillary revenues related to these businesses.

§ Capital Markets provides a broad spectrum of financial services for the investment and banking communities through the integration of capital markets securities activities, equity research and investment banking.

§ Corporate consists of unallocated corporate expenses, expense on subordinated debt issuances and preferred stock, bank-owned life insurance, unallocated interest income associated with excess equity, net impact of raising incremental capital, funds management and venture capital.

For the purpose of this management discussion and analysis (MD&A), earning assets have been expressed as averages, and loans have been disclosed net of unearned income. The following is a discussion and analysis of the financial condition and results of operations of FHN for the three-month and nine-month periods ended September 30, 2006, compared to the three-month and nine-month periods ended September 30, 2005. To assist the reader in obtaining a better understanding of FHN and its performance, this discussion should be read in conjunction with FHN's unaudited consolidated condensed financial statements and accompanying notes appearing in this report. Additional information including the 2005 financial statements, notes, and MD&A is provided in the 2005 Annual Report.

## **FORWARD-LOOKING STATEMENTS**

This MD&A contains forward-looking statements with respect to FHN's beliefs, plans, goals, expectations, and estimates. Forward-looking statements are statements that are not a representation of historical information but rather are related to future operations, strategies, financial results or other developments. The words "believe," "expect," "anticipate," "intend," "estimate," "should," "is likely," "will," "going forward," and other expressions that indicate future events and trends identify forward-looking statements. Forward-looking statements are necessarily based upon estimates and assumptions that are inherently subject to significant business, operational, economic and competitive uncertainties and contingencies, many of which are beyond a company's control, and many of which, with respect to future business decisions and actions (including acquisitions and divestitures), are subject to change. Examples of uncertainties and contingencies include, among other important factors, general and local economic and business conditions; expectations of and actual timing and amount of interest rate movements, including the slope of the yield curve (which can have a significant impact on a financial services institution); market and monetary fluctuations; inflation or deflation; customer and investor responses to these conditions; the financial condition of borrowers and other counterparties; competition within and outside the financial services industry; geopolitical developments including possible terrorist activity; natural disasters; effectiveness of FHN's hedging practices; technology; demand for FHN's

product offerings; new products and services in the industries in which FHN operates; and critical accounting estimates. Other factors are those inherent in originating and servicing loans including prepayment risks, pricing concessions, fluctuation in U.S. housing prices, fluctuation of collateral values, and changes in customer profiles. Additionally, the actions of the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, and

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other regulators; regulatory and judicial proceedings and changes in laws and regulations applicable to FHN; and FHN's success in executing its business plans and strategies and managing the risks involved in the foregoing, could cause actual results to differ. FHN assumes no obligation to update any forward-looking statements that are made from time to time. Actual results could differ because of several factors, including those presented in this Forward-Looking Statements section.

## **FINANCIAL SUMMARY (Comparison of Third Quarter 2006 to Third Quarter 2005)**

### **FINANCIAL HIGHLIGHTS**

Earnings for third quarter 2006 were \$67.1 million or \$.53 per diluted share. This quarter's results included estimated settlement costs of \$21.3 million for a class action lawsuit. Additionally, the interest rate environment and lower home mortgage demand negatively impacted the Mortgage Banking segment. Earnings for third quarter 2005 were \$112.9 million or \$.87 per diluted share.

Business operations reflected continued progress within Retail/Commercial Banking, with loan growth of 15 percent and deposit growth of 9 percent - achieved through growth within the Tennessee banking franchise and continued expansion into new markets. In addition, the development and distribution of capital market products other than fixed income continued to positively impact results with an increase of 38 percent this quarter compared to third quarter 2005. An inverted yield curve resulted in reduced net interest income for Mortgage Banking as an additional 115 basis points of compression on the warehouse spread contributed to a 50 percent decrease in net interest income. Additionally, a 31 percent drop in the warehouse related to lower origination activity negatively impacted net interest income. Mortgage Banking's origination revenues fell as loans delivered into the secondary market decreased 39 percent. Net servicing revenues were negatively impacted by hedging activities and changes in the value of MSR compared to last year's results. However, servicing fees increased, reflecting mortgage servicing portfolio growth and an increase in the mix of higher fee products.

Return on average shareholders' equity and return on average assets were 10.9 percent and .67 percent, respectively, for third quarter 2006. Return on average shareholders' equity and return on average assets were 20.2 percent and 1.18 percent, respectively, for third quarter 2005. Total assets were \$40.1 billion and shareholders' equity was \$2.5 billion on September 30, 2006, compared to \$37.0 billion and \$2.3 billion, respectively, on September 30, 2005.

### **BUSINESS LINE REVIEW**

#### **Retail/Commercial Banking**

Pre-tax income for Retail/Commercial Banking increased 5 percent to \$114.7 million for third quarter 2006, compared to \$109.3 million for third quarter 2005. Total revenues for Retail/Commercial Banking increased 3 percent to \$342.3 million for third quarter 2006 compared to \$331.4 million for third quarter 2005.

Net interest income increased 3 percent to \$231.9 million in third quarter 2006 from \$224.8 million in third quarter 2005 as earning assets grew 5 percent, or \$1.0 billion. Loans grew 15 percent or \$2.8 billion while loans held for sale

decreased 81 percent or \$1.8 billion and deposits increased 9 percent or \$1.0 billion over third quarter 2005. The Retail/Commercial Banking net interest margin was 4.21 percent in third quarter 2006 compared to 4.28 percent in the third quarter of last year. This compression reflects competitive positioning as the current cycle of Fed rate increases apparently came to an end.

Noninterest income increased 4 percent to \$110.4 million in third quarter 2006 from \$106.6 million in third quarter 2005. Fees from deposit transactions and cash management increased 8 percent or \$3.2 million compared to third quarter 2005 due to deposit growth and pricing initiatives. In 2005, a charge of \$3.9 million resulted from a write-off of net capitalized expenses on home equity lines of credit (HELOC) held for sale, which prepaid faster than anticipated. Additionally, third quarter 2005 included \$3.1 million from a settlement received from an insurance company.

Provision for loan losses increased to \$23.6 million in third quarter 2006 from \$22.4 million last year. The 2005 provision included \$3.8 million of hurricane losses. Excluding this item, the prior year provision for loan losses would have been \$18.6 million. The \$5.0 million increase primarily reflects an expectation of slowing economic growth and the migration of a few loans to the watch list.

Noninterest expense was relatively stable, increasing 2 percent to \$204.0 million in third quarter 2006 compared to \$199.7 million last year. This increase includes \$5.2 million related to the expansion of national businesses within Retail/Commercial Banking. This stability reflects a continued focus on efficiency, which resulted in a 60 basis point improvement in the efficiency ratio in third quarter 2006, compared to the prior year.

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### **Mortgage Banking**

Mortgage Banking had a pre-tax loss of \$25.5 million for third quarter 2006, compared to pre-tax income of \$60.6 million for third quarter 2005. Total revenues for Mortgage Banking were \$118.2 million in third quarter 2006 compared to \$193.0 million in third quarter 2005.

Net interest income decreased 50 percent to \$20.9 million in third quarter 2006 from \$41.8 million in third quarter 2005. An inverted yield curve resulted in compression of the spread on the warehouse, which was 1.18 percent in third quarter 2006 compared to 2.33 percent for the same period in 2005. Additionally, a 31 percent decrease in the warehouse related to lower origination activity negatively impacted net interest income.

Noninterest income decreased to \$97.3 million in third quarter 2006 compared to \$151.2 million in third quarter 2005. Noninterest income consists primarily of mortgage banking-related revenue, net of costs, from the origination and sale of mortgage loans, fees from mortgage servicing and changes in fair value of mortgage servicing rights (MSR) net of hedge gains or losses. Mortgage servicing noninterest income, prior to the adoption of Statement of Financial Accounting Standards No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140" (SFAS No. 156) in first quarter 2006, was net of amortization, impairment and other expenses related to MSR and related hedges. Subsequent to the adoption of SFAS No. 156, mortgage servicing noninterest income reflects the change in fair value of MSR combined with hedging results.

Net origination income decreased 41 percent to \$67.7 million from \$115.5 million in third quarter 2005 as loans delivered into the secondary market decreased 39 percent to \$6.5 billion. Total mortgage servicing fees increased 24 percent to \$86.2 million from \$69.7 million reflecting mortgage servicing portfolio growth of 7 percent to \$100.2 billion on September 30, 2006. Servicing fees also benefited from an increase in the mix of higher fee products.

Servicing hedging activities and write-off of MSR values negatively impacted net servicing revenues by \$24.4 million this quarter as compared to a year ago. Changes in the value of MSR due to factors other than runoff net of hedge results reflected a net loss of \$5.8 million in third quarter 2006 compared to a gain of \$30.3 million during the same

period last year. Additionally, although the value of MSR that prepaid this quarter was more valuable than a year ago, overall prepayments declined with lower refinance activity, causing the change in MSR value due to runoff to decrease to \$60.3 million from \$72.0 million last year.

Other noninterest income decreased \$3.8 million. Third quarter 2005 included a settlement of \$4.6 million from an insurance company. Income from a deferred compensation plan increased \$1.7 million from third quarter 2005. This increase in revenue was matched by a corresponding \$1.7 million increase in noninterest expense associated with this plan.

Noninterest expense increased 9 percent or \$11.4 million to \$143.6 million in third quarter 2006 compared to \$132.2 million in third quarter 2005. Excluding \$21.3 million for the estimated costs of settling a class action lawsuit, noninterest expense decreased 8 percent primarily due to reductions in personnel expense, which were directly related to the contraction in origination revenue.

### **Capital Markets**

Capital Markets pre-tax earnings were \$13.8 million in third quarter 2006 compared to \$2.5 million in third quarter 2005. Total revenues for Capital Markets were \$100.1 million in third quarter 2006 compared to \$78.5 million in third quarter 2005.

Revenues from products other than fixed income were \$56.7 million in third quarter 2006, an increase of \$15.6 million, or 38 percent, from third quarter 2005. Revenues from other products include fee income from activities such as structured finance, equity research, investment banking, loan sales, portfolio advisory and the sale of bank-owned life insurance. These other sources of revenue represented 58 percent of total product revenues in third quarter 2006 compared to 48 percent in third quarter 2005. The increase from third quarter 2005 was due to increased fees from structured finance activities. Revenues from fixed income sales decreased \$2.4 million, or 5 percent, to \$41.5 million in third quarter 2006 compared to \$43.9 million in third quarter 2005 reflecting the current interest rate environment and its continuing negative impact on the demand for fixed income products. Other non-product revenues relating to a deferred compensation plan increased \$1.8 million from third quarter 2005. This increase in revenue was offset by a related \$2.1 million increase in noninterest expense associated with this plan.

Net interest expense decreased \$6.3 million in third quarter 2006 compared to third quarter 2005 primarily due to an increase in net average earning assets, improved execution that decreased nonearning asset funding costs and a decrease in the internal incremental cost of equity.

Noninterest expense was \$86.3 million in third quarter 2006 compared to \$76.0 million in third quarter 2005. This increase was primarily due to variable compensation related to the increase in other product revenues and a \$2.1 million increase in deferred compensation plan expense mentioned above.

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### **Corporate**

The Corporate segment's results yielded a pre-tax loss of \$10.1 million in third quarter 2006 compared to a pre-tax loss of \$14.4 million in third quarter 2005. The third quarter 2006 results include \$8.8 million of net securities gains from the sale of MasterCard Inc. securities and net securities gains from venture capital investments. Noninterest expense growth resulted from the write-off of a holding company investment, venture capital commissions and project costs.

### **INCOME STATEMENT REVIEW**

Total revenues (net interest income and noninterest income) decreased 6 percent to \$573.0 million in third quarter 2006 from \$606.7 million in 2005. Noninterest income was \$321.4 million in third quarter 2006 compared to \$346.6 million in 2005, and net interest income was \$251.6 million in 2006 compared to \$260.1 million in 2005. A more

detailed discussion of the major line items follows.

## NET INTEREST INCOME

Net interest income decreased 3 percent to \$251.6 million as earning assets grew 3 percent to \$34.6 billion and interest-bearing liabilities grew 5 percent to \$30.0 billion in third quarter 2006.

The activity levels and related funding for FHN's mortgage production and servicing and capital markets activities affect the net interest margin. These activities typically produce different margins than traditional banking activities. Mortgage production and servicing activities can affect the overall margin based on a number of factors, including the shape of the yield curve, the size of the mortgage warehouse, the time it takes to deliver loans into the secondary market, the amount of custodial balances, and the level of MSR. Capital markets activities tend to compress the margin because of its strategy to reduce market risk by economically hedging a portion of its inventory on the balance sheet. As a result of these impacts, FHN's consolidated margin cannot be readily compared to that of other bank holding companies.

The consolidated net interest margin was 2.90 percent for third quarter 2006 compared to 3.09 percent for third quarter 2005. This compression in the margin occurred as the net interest spread decreased to 2.25 percent from 2.59 percent in 2005 while the impact of free funding increased from 50 basis points to 65 basis points. The decline in margin is attributable to an inverted yield curve, which decreased spread on the warehouse by 115 basis points to 1.18 percent.

**Table 1 - Net Interest Margin**

	Three Months Ended September 30	
	2006	2005
<b>Consolidated Yields and Rates:</b>		
Loans, net of unearned income	7.59%	6.34%
Loans held for sale	6.86	6.43
Investment securities	5.67	4.30
Capital markets securities inventory	5.41	5.01
Mortgage banking trading securities	11.31	12.82
Other earning assets	5.17	3.07
<b>Yields on earning assets</b>	<b>7.04</b>	<b>5.90</b>
Interest-bearing core deposits	3.17	2.13
Certificates of deposits \$100,000 and more	5.36	3.53
Federal funds purchased and securities sold under agreements to repurchase	4.83	3.18
Capital markets trading liabilities	5.61	5.54
Commercial paper and other short-term borrowings	5.25	3.62
Long-term debt	5.80	4.16
<b>Rates paid on interest-bearing liabilities</b>	<b>4.79</b>	<b>3.31</b>
<b>Net interest spread</b>	<b>2.25</b>	<b>2.59</b>
Effect of interest-free sources	.65	.50
<b>FHN - NIM</b>	<b>2.90%</b>	<b>3.09%</b>

In the near-term, a modest compression of the net interest margin is expected as further inversion of the yield curve generally has a continued unfavorable impact on net interest margin, primarily from narrower spreads on the mortgage warehouse.

## NONINTEREST INCOME

**Mortgage Banking Noninterest Income**

First Horizon Home Loans, an indirect subsidiary of FHN, offers residential mortgage banking products and services to customers, which consist primarily of the origination or purchase of single-family residential mortgage loans. First Horizon Home Loans originates mortgage loans through its retail and wholesale operations and also purchases mortgage loans from third-party mortgage bankers for sale to secondary market investors and subsequently provides servicing for the majority of those loans.

Origination income includes origination fees, net of costs, gains/(losses) recognized on loans sold including the capitalized fair value of MSR, and the value recognized on loans in process including results from hedging. Origination fees, net of costs (including incentives and other direct costs), are deferred and included in the basis of the loans in calculating gains and losses upon sale. Gain or loss is recognized due to changes in fair value of an interest rate lock commitment made to the customer. Gains or losses from the sale of loans are recognized at the time a mortgage loan is sold into the secondary market. Origination income decreased 41 percent to \$67.7 million from \$115.5 million in third quarter 2005 as loans delivered into the secondary market decreased 39 percent to \$6.5 billion.

Servicing income includes servicing fees and net gains or losses from hedging MSR. Prior to the adoption of SFAS No. 156 in first quarter 2006, mortgage servicing noninterest income was net of amortization, impairment and other expenses related to MSR and related hedges. Subsequent to the adoption of SFAS No. 156, mortgage servicing noninterest income reflects the change in fair value of the MSR asset combined with net hedging results. First Horizon Home Loans employs hedging strategies intended to counter changes in the value of MSR and other retained interests due to changing interest rate environments (refer to discussion of MSR under Critical Accounting Policies). Total mortgage servicing fees increased 24 percent to \$86.2 million from \$69.7 million primarily reflecting mortgage servicing portfolio growth of 7 percent to \$100.2 billion on September 30, 2006. Servicing fees also benefited from an increase in the mix of higher fee products.

Servicing hedging activities and write-off of MSR values negatively impacted net servicing revenues by \$24.4 million this quarter as compared to a year ago. Changes in the value of MSR due to factors other than runoff net of hedge results reflected a net loss of \$5.8 million in third quarter 2006 compared to a gain of \$30.3 million during the same period last year. Additionally, although the value of MSR that prepaid this quarter was more valuable than a year ago; overall prepayments declined with lower refinance activity, causing the change in MSR value due to runoff to decrease to \$60.3 million from \$72.0 million last year.

Other income includes FHN's share of earnings from nonconsolidated subsidiaries accounted for under the equity method, which provide ancillary activities to mortgage banking and fees from retail construction lending.

**Table 2 - Mortgage Banking Noninterest Income**

	Three Months Ended September 30		Percent Change (%)	Nine Months Ended September 30		Percent Change (%)
	2006	2005		2006	2005	
<i>(Dollars in thousands and volumes in millions)</i>						
<b>Noninterest income:</b>						
Origination income	\$ 67,705	\$ 115,541	41.4 -	\$ 247,436	\$ 311,181	20.5 -
Servicing income	15,701	17,951	12.5 -	25,691	38,013	32.4 -
Other	5,987	6,990	14.3 -	18,529	19,043	2.7 -
Total mortgage banking noninterest income	\$ 89,393	\$ 140,482	36.4 -	\$ 291,656	\$ 368,237	20.8 -
Refinance originations	\$ 2,091.8	\$ 4,386.6	52.3 -	\$ 7,389.2	\$ 11,519.7	35.9 -
Home-purchase originations	4,258.7	6,170.0	31.0 -	13,308.1	16,181.0	17.8 -
Mortgage loan originations	\$ 6,350.5	\$ 10,556.6	39.8 -	\$ 20,697.3	\$ 27,700.7	25.3 -



Servicing portfolio                      \$ 100,245.7    \$ 93,589.4            7.1 +    \$ 100,245.7    \$ 93,589.4            7.1 +

### Capital Markets Noninterest Income

Capital markets noninterest income, the major component of revenue in the Capital Markets segment, is generated from the purchase and sale of securities as both principal and agent, and from other fee sources including structured finance, equity research, investment banking, loans sales, and portfolio advisory activities. Inventory positions are limited to the procurement of securities solely for distribution to customers by the sales staff. A portion of the inventory is hedged to protect against movements in fair value due to changes in interest rates.

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Revenues from fixed income sales decreased \$2.4 million compared to third quarter 2005 reflecting the current interest rate environment and its continuing negative impact on the demand for fixed income products. Revenues from other fee sources increased \$15.4 million primarily due to increased fees from structured finance activities.

**Table 3 - Capital Markets  
Noninterest Income**

<i>(Dollars in thousands)</i>	Three Months Ended		Growth Rate (%)	Nine Months Ended		Growth Rate (%)
	September 30 2006	2005		September 30 2006	2005	
<b>Noninterest income:</b>						
Fixed income	\$ 41,503	\$ 43,870	5.4 -	\$ 133,948	\$ 157,708	15.1 -
Other product revenue	53,712	38,288	40.3 +	156,290	114,401	36.6 +
Total capital markets noninterest income	\$ 95,215	\$ 82,158	15.9 +	\$ 290,238	\$ 272,109	6.7 +

Certain previously reported amounts have been reclassified to agree with current presentation.

### Other Noninterest Income

Other noninterest income includes deposit transactions and cash management fees, insurance commissions, revenue from loan sales and securitizations, trust services and investment management fees, net securities gains and losses and other noninterest income. Third quarter 2006 noninterest income included \$8.8 million of net securities gains from the sale of MasterCard Inc. securities and net securities gains from venture capital investments. Deposit transactions and cash management fees increased \$3.2 million or 8 percent, reflecting deposit growth and pricing initiatives. Insurance commissions decreased \$2.1 million, or 17 percent, primarily due to the divestiture of two subsidiaries in third quarter 2006, which also resulted in a divestiture gain of \$2.6 million in other noninterest income. Other noninterest income increased \$3.3 million reflecting several impacts, including: a \$3.9 million charge incurred in 2005 resulting from a write-off of net capitalized expenses on HELOC held for sale which prepaid faster than anticipated; an increase in 2006 of \$3.5 million in other revenues related to deferred compensation plans (offset by a related increase in noninterest expense associated with these plans); the \$2.6 million gain in third quarter 2006 from the sale of an insurance subsidiary; and in third quarter 2005 a \$7.7 million settlement received from an insurance company.

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### NONINTEREST EXPENSE

Total noninterest expense for third quarter 2006 increased 7 percent to \$456.4 million from \$426.1 million in 2005. Employee compensation, incentives and benefits (personnel expense), the largest component of noninterest expense, was stable at \$260.3 million compared to \$259.5 million in 2005. Included in these results was an increase of \$4.2 million in 2006 related to deferred compensation plans for which, as discussed above, there was a corresponding increase in revenue. These results reflect a continued corporate focus on efficiency and reductions in personnel expense in mortgage banking directly related to the contraction in origination revenue which offset higher expenses

associated with national expansion initiatives, and an increase in variable compensation associated with the growth in capital markets' other product revenues. Occupancy expense increased \$3.7 million, or 14 percent, due primarily to expansion initiatives. All other noninterest expense increased 34 percent, or \$28.8 million, which included the estimated settlement costs of \$21.3 million for a class action lawsuit.

## INCOME TAXES

The effective tax rate for third quarter 2006 was 28 percent reflecting the settlement of certain prior years audits and the natural impact of an average tax rate when earnings are below historical levels as all incremental impacts to earnings bear a higher incremental tax rate. Also impacting the effective tax rate was an increase related to the sale of two insurance subsidiaries and a decrease related to the performance of certain deferred compensation related life insurance policies.

## PROVISION FOR LOAN LOSSES / ASSET QUALITY

The provision for loan losses is the charge to earnings that management determines to be necessary to maintain the allowance for loan losses at an adequate level reflecting management's estimate of probable incurred losses in the loan portfolio. An analytical model based on historical loss experience adjusted for current events, trends and economic conditions is used by management to determine the amount of provision to be recognized and to assess the adequacy of the loan loss allowance. The provision for loan losses was \$23.7 million in third quarter 2006 compared to \$22.6 million in third quarter 2005. The 2005 provision included \$3.8 million of hurricane losses. Excluding this item, the provision for loan losses would have increased \$4.9 million, primarily reflecting an expectation of slowing economic growth and the migration of a few loans to the watch list. The net charge-off ratio was 30 basis points in third quarter 2006 compared to 20 basis points in third quarter 2005 as net charge-offs grew to \$16.4 million from \$9.2 million during a period of strong loan growth.

**Table 4 - Net Charge-off Ratios \***

	Three Months Ended September 30	
	2006	2005
Commercial	.28%	.09%
Retail real estate	.25	.20
Other retail	2.71	1.96
Credit card receivables	1.99	3.11
Total net charge-offs	.30	.20

\* Table 6 provides information on the relative size of each loan portfolio.

Nonperforming loans in the loan portfolio were \$64.0 million on September 30, 2006, compared to \$39.2 million on September 30, 2005. The ratio of nonperforming loans in the loan portfolio to total loans was 29 basis points on September 30, 2006, and 20 basis points on September 30, 2005. The \$24.8 million increase in nonperforming loans reflects some migration from historically low levels as the loan portfolio matured and modest deterioration of a few commercial credits in the retail commercial bank's traditional lending markets. Nonperforming assets were \$118.0 million on September 30, 2006, compared to \$79.0 million on September 30, 2005. The nonperforming assets ratio was 49 basis points on September 30, 2006, and 35 basis points last year. In addition to the increase in nonperforming loans, foreclosed assets increased \$15.7 million, which can be attributed to the growth and maturing of the retail loan portfolio. Foreclosed assets are either charged-off or written down to net realizable value at foreclosure. The nonperforming asset ratio was expected to experience some deterioration as the loan portfolio matured.

Potential problem assets in the loan portfolio, which are not included in nonperforming assets, represent those assets where information about possible credit problems of borrowers has caused management to have serious doubts about the borrower's ability to comply with present repayment terms. This definition is believed to be substantially consistent

with the standards established by the Office of the Comptroller of the Currency for loans classified substandard. In total, potential problem assets were \$148.4 million on September 30, 2006,

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compared to \$154.8 million on September 30, 2005. The current expectation of losses from potential problem assets has been included in management's analysis for assessing the adequacy of the allowance for loan losses.

Going forward the level of provision for loan losses should fluctuate primarily with the strength or weakness of the economies of the markets where FHN does business over the long-run and will experience quarterly fluctuations depending on the type and quantity of loan growth and impacts from quarterly asset quality movements. Asset quality indicators are expected to remain positive; however, a gradual increase from the historically low levels experienced in recent periods is expected.

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**Table 5 - Asset Quality Information**

<i>(Dollars in thousands)</i>	Third Quarter	
	2006	2005
<b>Allowance for loan losses:</b>		
Beginning balance on June 30	\$ 199,835	\$ 169,697
Provision for loan losses	23,694	22,608
Divestiture/Acquisitions	(275)	1,902
Charge-offs	(19,782)	(12,900)
Recoveries	3,357	3,722
Ending balance on September 30	\$ 206,829	\$ 185,029
Reserve for off-balance sheet commitments	9,230	9,034
Total allowance for loan losses and reserve for off-balance sheet commitments	\$ 216,059	\$ 194,063
	September 30	
	2006	2005
<b>Retail/Commercial Banking:</b>		
Nonperforming loans	\$ 63,956	\$ 39,236
Foreclosed real estate	29,947	19,875
Total Retail/Commercial Banking	93,903	59,111
<b>Mortgage Banking:</b>		
Nonperforming loans - held for sale	10,488	11,868
Foreclosed real estate	13,598	7,981
Total Mortgage Banking	24,086	19,849
Total nonperforming assets	\$ 117,989	\$ 78,960
Total loans, net of unearned income	\$ 21,944,320	\$ 19,211,703
Insured loans	(730,453)	(667,457)
Loans excluding insured loans	\$ 21,213,867	\$ 18,544,246
Foreclosed real estate from GNMA loans*	\$ 21,679	\$ -
Potential problem assets**	148,356	154,846
Loans 30 to 89 days past due	104,957	97,716
Loans 30 to 89 days past due - guaranteed portion***	179	2,472
Loans 90 days past due	28,246	29,324
Loans 90 days past due - guaranteed portion***	185	5,482

Loans held for sale 30 to 89 days past due	<b>30,288</b>	37,678
Loans held for sale 30 to 89 days past due - guaranteed portion***	<b>24,226</b>	18,548
Loans held for sale 90 days past due	<b>132,416</b>	163,832
Loans held for sale 90 days past due - guaranteed portion***	<b>130,188</b>	161,409
Off-balance sheet commitments****	<b>7,415,880</b>	8,750,863
Allowance to total loans	<b>.94%</b>	.96%
Allowance to loans excluding insured loans	<b>.97</b>	1.00
Allowance to nonperforming loans in the loan portfolio	<b>323</b>	472
Nonperforming assets to loans, foreclosed real estate and other assets (Retail/Commercial Banking)	<b>.44</b>	.31
Nonperforming assets to unpaid principal balance of servicing portfolio (Mortgage Banking)	<b>.02</b>	.02
Allowance to annualized net charge-offs	<b>3.15x</b>	5.04x

\* Prior to 2006 properties acquired by foreclosure through GNMA's repurchase program were classified as receivables in "Other assets" on the Consolidated Condensed Statements of Condition.

\*\* Includes past due loans.

\*\*\* Guaranteed loans include FHA, VA, student and GNMA loans repurchased through the GNMA repurchase program.

\*\*\*\* Amount of off-balance sheet commitments for which a reserve has been provided. In 2006, a reserve has been provided for unfunded credit card commitments.

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## **STATEMENT OF CONDITION REVIEW**

### **EARNING ASSETS**

During third quarter 2006, earning assets consisted of loans, loans held for sale, investment securities, trading securities and other earning assets. Earning assets grew 3 percent and averaged \$34.6 billion in third quarter 2006 compared to \$33.6 billion in 2005, as loan growth was largely offset by a decline in loans held for sale related to lower origination activity. Investment securities grew 30 percent reflecting the purchase of approximately \$.9 billion U.S. government agency securities to partially offset the decrease in loans held for sale and take advantage of attractive yields.

### **LOANS**

Average total loans increased 16 percent for third quarter 2006 to \$21.8 billion from \$18.7 billion in 2005. Average loans represented 63 percent of average earning assets in third quarter 2006 and 56 percent in 2005.

Commercial, financial and industrial loans increased 10 percent, or \$627.3 million, since third quarter 2005 reflecting increased market share in Tennessee, expansion into other markets, the addition of middle market lending to the Atlanta, Dallas and Virginia markets, and continued economic growth. Commercial construction loans grew 48 percent since third quarter 2005 or \$839.7 million, primarily from growth in loans to single-family residential builders made through First Horizon Home Loans, reflecting the seasoning of the sales force and geographic diversification. Retail real estate residential loans increased 12 percent or \$908.3 million reflecting growing demand for second-lien mortgages. The retail real estate construction portfolio increased 26 percent or \$422.0 million since third quarter 2005. Retail real estate construction loans are a one-time close product where First Horizon Home Loans provides construction financing and a permanent mortgage to individuals for the purpose of constructing a home. Upon completion of construction, the permanent mortgage is classified as held for sale and sold into the secondary market. The increase in these loans reflects the recent housing market conditions and further penetration of our customer base. Additional loan information is provided in Table 6 - Average Loans.

FHN has a significant concentration in loans secured by real estate, which is geographically diversified nationwide. In 2006, 66 percent of total loans are secured by real estate compared to 65 percent in 2005 (see Table 6). Three lending products have contributed to this level of real estate lending including significant levels of retail residential real estate, which comprise 39 percent of total loans. The risk profile of the retail residential real estate portfolio remains stable reflecting a significant concentration of high credit score products. Also contributing to the level of real estate lending is commercial construction lending which comprises 12 percent of total loans and includes loans to single-family builders, and retail real estate construction loans, First Horizon Home Loan's one-time close product, which comprise 9 percent of total loans. FHN's commercial real estate lending is well diversified by product type and industry. On September 30, 2006, FHN did not have any concentrations of 10 percent or more of commercial, financial and industrial loans in any single industry.

**Table 6 - Average Loans**

<i>(Dollars in millions)</i>	2006	Three Months Ended September 30		2005	Percent of Total
		Percent of Total	Growth Rate		
<b>Commercial:</b>					
Commercial, financial and industrial	\$ 6,803.5	31%	10.2%	\$ 6,176.2	33%
Real estate commercial	1,221.4	6	5.0	1,163.2	6
Real estate construction	2,575.6	12	48.4	1,735.9	9
Total commercial	10,600.5	49	16.8	9,075.3	48
<b>Retail:</b>					
Real estate residential	8,502.0	39	12.0	7,593.7	41
Real estate construction	2,065.9	9	25.7	1,643.9	9
Other retail	160.4	1	(4.2)	167.5	1
Credit card receivables	201.3	1	(16.7)	241.6	1
Real estate loans pledged against other collateralized borrowings	268.1	1	NM	-	-
Total retail	11,197.7	51	16.1	9,646.7	52
Total loans, net of unearned	\$ 21,798.2	100%	16.4%	\$ 18,722.0	100%

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Commercial loan growth should be strong as a result of the national expansion of single-family residential construction lending and greater market demand for commercial and industrial loans. Year-over-year growth in retail loans will be primarily driven by the national sales platform.

**LOANS HELD FOR SALE**

Loans held for sale consist of first-lien mortgage loans (warehouse), HELOC, second-lien mortgages, student loans, small issuer trust preferred securities and credit card receivables. The mortgage warehouse accounts for the majority of loans held for sale. Loans held for sale decreased 39 percent to \$4.2 billion in 2006 from \$6.9 billion in 2005. This decline is related to the lower demand for mortgages and HELOC while small issuer trust preferred securities held for sale increased. FHN continues to fund loan growth and maintain a stable liquidity position through whole-loan sales and securitizations.

**DEPOSITS / OTHER SOURCES OF FUNDS**

Core deposits increased 6 percent to \$13.2 billion in third quarter 2006 compared to \$12.5 billion in 2005, primarily due to growth in Retail/Commercial Banking deposits reflecting market share gains in Tennessee markets, new market

expansion and improved national cross-sell efforts. Short-term purchased funds averaged \$16.5 billion for third quarter 2006, down 15 percent or \$2.8 billion from third quarter 2005. In third quarter 2006, short-term purchased funds accounted for 47 percent of FHN's total funding down from 56 percent in third quarter 2005, which is comprised of core deposits, purchased funds (including federal funds purchased, securities sold under agreements to repurchase, trading liabilities, certificates of deposit greater than \$100,000, and short-term borrowings) and long-term debt. Long-term debt includes senior and subordinated borrowings, advances with original maturities greater than one year and other collateralized borrowings. Long-term debt averaged \$5.5 billion in third quarter 2006 compared to \$2.4 billion in third quarter 2005 (see Note 6 - Long-Term Debt for additional detail).

#### **FINANCIAL SUMMARY (Comparison of first nine months of 2006 to first nine months of 2005)**

Earnings were \$386.4 million or \$3.02 per diluted share for the nine months ended September 30, 2006, including the impact of the divestiture of FHN's national merchant processing business. Earnings were \$318.8 million or \$2.47 per diluted share for the nine months ended September 30, 2005. For the nine months ended September 30, 2006, return on average shareholders' equity and return on average assets were 21.6 percent and 1.34 percent, respectively. Return on average shareholders' equity and return on average assets were 19.9 percent and 1.18 percent, respectively, for the nine months ended September 30, 2005.

Comparisons between reported earnings are directly and significantly affected by a number of factors that were present in 2006 but not present (or present to a much lesser degree) in 2005. FHN's year-to-date performance in 2006 was impacted by estimated settlement costs of \$21.3 million for a class action lawsuit. Additionally, performance in 2006 was impacted by the gain on the merchant divestiture, transactions through which the incremental capital provided by the divestiture was utilized, various other transactions, and accounting matters. The following discussion highlights these items:

On March 1, 2006, FHN sold its national merchant processing business for an after-tax gain of \$209 million. This divestiture was accounted for as a discontinued operation, and accordingly, all periods presented were adjusted to exclude the impact of merchant operations from the results of continuing operations. In tandem with the merchant sale, FHN purchased 4 million shares of its common stock to minimize the potentially dilutive effect of the merchant divestiture on future earnings per share. Also included in results from continuing operations are securities losses of \$68.6 million, predominantly related to repositioning approximately \$2.3 billion of investment securities. Partially offsetting these securities losses were net securities gains of \$10.4 million in 2006 from the sale of MasterCard Inc. securities and from venture capital investments.

FHN determined that certain derivative transactions used in hedging strategies to manage interest rate risk did not qualify for hedge accounting under the "short cut" method, as have a number of other banks. As a result, any fluctuations in the market value of the derivatives should have been recorded through the income statement with no corresponding offset to the hedged item. While management believes these hedges would have qualified for hedge accounting under the "long haul" method, that accounting method could not be applied retroactively. FHN evaluated the impact to all quarterly and annual periods since the inception of the hedges and concluded that the impact was immaterial in each period. In first quarter 2006, FHN recorded an adjustment to recognize the cumulative impact of these transactions that resulted in a negative \$15.6 million impact to noninterest income, which was included in continuing operations. FHN has subsequently redesignated these hedge relationships under Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS No. 133), using the "long haul" method.

Various other items impacted results from continuing operations. A pre-tax loss of \$12.7 million was recognized from the sale of HELOC upon which the borrower had not drawn funds. The loss represents deferred loan origination costs, generally recognized over the life of the

loan, which were recognized when the line of credit was sold. Mortgage banking experienced foreclosure losses and other expenses related to nonprime mortgage loans. In addition, expenses associated with devaluing inventories, consolidating operations and closing offices, incremental expenditures on technology, and compensation expense related to early retirement, severance and retention were recognized in 2006 but will reduce costs and should improve performance going forward.

2006 earnings also included a favorable impact of \$1.3 million or \$.01 per diluted share from the cumulative effect of changes in accounting principles. FHN adopted SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123-R) in first quarter 2006 and retroactively applied the provisions of the standard. Accordingly, results for periods prior to 2006 have been adjusted to reflect expensing of share-based compensation. A cumulative effect adjustment of \$1.1 million was recognized, reflecting the change in accounting for share-based compensation expense based on estimated forfeitures rather than actual forfeitures. FHN also adopted SFAS No. 156, "Accounting for Servicing of Financial Assets," which allows servicing assets to be measured at fair value with changes in fair value reported in current earnings. The adoption of this standard was applied on a prospective basis and resulted in a cumulative effect adjustment of \$.2 million, representing the excess of the fair value of the servicing asset over the recorded value on January 1, 2006.

### **INCOME STATEMENT REVIEW**

For the first nine months of 2006, total revenues were \$1,610.0 million, a decrease of 6 percent from \$1,718.8 million in 2005. Noninterest income for the first nine months of 2006 was \$859.1 million and contributed 53 percent to total revenues as compared to \$989.6 million, or 58 percent of total revenues in 2005.

Mortgage banking fee income decreased 21 percent to \$291.6 million from \$368.2 million. During this period, fees from the origination process decreased 21 percent to \$247.4 million from \$311.2 million for 2005 as loans sold into the secondary market decreased 22 percent. Additionally, mortgage loan originations decreased to \$20.7 billion in 2006 from \$27.7 billion in 2005 as refinance activity dropped 36 percent.

Total mortgage servicing fees increased 19 percent or \$38.4 million to \$244.3 million in 2006 from \$205.9 million in 2005 reflecting 7 percent growth in the servicing portfolio and an increase in the mix of higher fee products. Changes in the value of MSR due to factors other than runoff net of hedge results reflected a net loss of \$10.7 million in 2006 as compared to a net gain of \$68.0 million in 2005. Specifically, significant flattening of the yield curve reduced net interest income derived from swaps utilized to hedge MSR. Although the value of MSR that prepaid this year was more valuable than a year ago, overall prepayments declined with lower refinance activity. The MSR value due to runoff negatively impacted servicing revenue by \$191.4 million in 2006 compared to \$199.5 million last year. In addition, decreased option expense on servicing hedges resulted in a \$22.1 million increase in servicing income compared to 2005. See Table 2 - Mortgage Banking Noninterest Income for a breakout of noninterest income as well as mortgage banking origination volume and servicing portfolio levels.

Noninterest income from capital markets increased 7 percent to \$290.2 million from \$272.1 million for 2005 reflecting increased fees from investment banking and structured finance activities partially offset by a decline in fees from fixed income products. Deposit transactions and cash management fees increased 10 percent, or \$11.2 million, to \$125.3 million, reflecting deposit growth and pricing initiatives. Net securities losses of \$68.6 million were primarily related to the restructuring of the investment portfolio in the first quarter 2006, net of gains from the sale of MasterCard Inc. securities and from venture capital investments, previously mentioned. Other noninterest income decreased 8 percent, or \$10.1 million, to \$116.4 million. Contributing to this decline was the negative \$15.6 million cumulative impact of derivative transactions used in hedging strategies to manage interest rate risk that management determined did not qualify for hedge accounting under the "short cut" method in 2006. Other noninterest income was also impacted by a \$9.1 million write-off of net capitalized expenses on HELOC held for sale that prepaid faster than

anticipated and a \$7.7 million favorable settlement received from an insurance company in 2005.

Net interest income increased 3 percent to \$750.9 million from \$729.2 million for the first nine months of 2006 while earning assets increased 8 percent to \$33.9 billion from \$31.5 billion in 2005. The year-to-date consolidated margin decreased to 2.96 percent in 2006 from 3.09 percent in 2005 reflecting a flatter yield curve which resulted in compression of net interest spread.

Total noninterest expense for the first nine months of 2006 increased 8 percent to \$1,319.6 million from \$1,216.9 million in 2005. Personnel expense increased \$22.4 million or 3 percent in 2006, primarily due to higher expenses associated with national expansion initiatives, and an increase in variable compensation associated with the growth in capital markets' other product revenues. These increases were partially offset by a continued corporate focus on efficiency and reductions in personnel expense in mortgage banking directly related to the contraction in origination revenue. Early retirement, severance and retention costs also contributed to this increase. All other expense categories increased 17 percent or \$80.3 million in 2006, which included the estimated settlement costs for a class action lawsuit, occupancy

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expense, incremental expense growth in the collectible coin business, losses due to certain misrepresentations within a previously identified pool of construction loans, nonprime mortgage loans, dividends on First Tennessee Bank National Association (FTBNA) perpetual preferred stock, consolidating operations, closing offices, and technology. The provision for loan losses increased 17 percent to \$60.1 million from \$51.5 million in the first nine months of 2005 primarily reflecting loan growth, an expectation of slowing economic growth and recent trends in net charge off levels.

## **BUSINESS LINE REVIEW**

### **Retail/Commercial Banking**

For the first nine months of 2006, pre-tax income increased to \$324.8 million from \$318.7 million in 2005. Total revenues for the nine-month period were \$1,016.2 million, an increase of 8 percent from \$942.1 million in 2005. Net interest income increased 8 percent, or \$52.7 million as earning assets grew 11 percent. Noninterest income increased 7 percent, or \$21.4 million primarily due to increased fees from deposit transactions and cash management, which increased \$11.2 million in 2006. In 2005, noninterest income was reduced by \$9.1 million resulting from a write-off of the net capitalized expenses on HELOC held for sale that prepaid faster than anticipated. Provision for loan losses increased 17 percent in 2006 to \$59.9 million from \$51.2 million, reflecting loan growth and an expectation of slowing economic growth. Total noninterest expense for the nine-month period increased 10 percent to \$631.5 million from \$572.2 million in 2005. The increase in noninterest expense was impacted by costs associated with the coin inventory valuation and closing of retail sites; incremental costs associated with national businesses; losses due to certain misrepresentations within a previously identified pool of construction loans; consolidation of remittance processing operations and office closing; and early retirement and severance costs.

### **Mortgage Banking**

For the first nine months of 2006 Mortgage Banking had a pre-tax loss of \$1.7 million compared to a pre-tax gain of \$148.4 million in 2005. Total revenues for the nine-month period were \$377.4 million, a decrease of 25 percent from \$504.4 million in 2005. During this period, fees from the origination process decreased \$63.7 million while net servicing income declined \$12.3 million. Total noninterest expense for the nine-month period increased 7 percent to \$378.9 million from \$355.7 million in 2005. Total noninterest expense increased primarily due to the estimated settlement costs for a class action lawsuit, higher level of losses associated with the nonprime origination business and costs associated with branch closings, including lease abandonment and severance expenses.

### **Capital Markets**



For the first nine months of 2006 pre-tax income increased 85 percent to \$36.7 million from \$19.9 million in 2005. Total revenues for the nine-month period were \$289.9 million, an increase of 11 percent from \$260.5 million in 2005 reflecting an increase in fees from products other than fixed income, primarily from investment banking and structured finance activities, partially offset by a decline in fees from fixed income products. Total noninterest expense increased 5 percent to \$253.2 million from \$240.6 million in 2005 primarily due to variable compensation related to the increase in other product revenues.

### Corporate

For the first nine months of 2006, Corporate had a pre-tax loss of \$129.5 million compared to a pre-tax loss of \$36.6 million in 2005. Included in 2006 were net securities losses of \$68.6 million primarily related to the restructuring of the investment portfolio in first quarter 2006, net of gains from the sale of MasterCard Inc. securities and from venture capital investments, previously mentioned. Also impacting 2006 was the negative \$15.6 million cumulative impact of derivative transactions used in hedging strategies to manage interest rate risk that management determined did not qualify for hedge accounting under the "short cut" method and an increase of \$6.4 million related to dividend expense on \$300.0 million of FTBNA's noncumulative perpetual preferred stock.

### CAPITAL

Management's objectives are to provide capital sufficient to cover the risks inherent in FHN's businesses, to maintain excess capital to well-capitalized standards and to assure ready access to the capital markets.

Average shareholders' equity increased 10 percent in third quarter 2006 to \$2.4 billion from \$2.2 billion, reflecting internal capital generation. Period-end shareholders' equity was \$2.5 billion on September 30, 2006, up 10 percent from September 30, 2005. This increase in shareholders' equity came principally from retention of net income after dividends and the effects of stock repurchases and option exercises. Pursuant to board authority, FHN may repurchase shares from time to time and will evaluate the level of capital and take action designed to generate or use capital as appropriate, for the interests of the shareholders. In order to maintain FHN's excess capital to well-capitalized status while sustaining strong balance sheet growth, FTBNA has issued approximately \$250 million of subordinated notes which qualify as Tier 2 capital under the risk-based capital guidelines since March 31, 2005.

In first quarter 2006, FHN entered into an agreement with Goldman Sachs & Co. to purchase four million shares of FHN common stock in connection with an accelerated share repurchase program under an existing share repurchase authorization. This share repurchase program was concluded for an adjusted purchase price of \$165.1 million in second quarter 2006. The share repurchase was funded with a portion of the proceeds from the merchant processing sale. The divestiture of merchant operations is not expected to have a material impact on future capital resources.

**Table 7 - Issuer Purchases of Equity Securities**

<i>(Volume in thousands)</i>	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs	Maximum Number of Shares that May Yet Be Purchased Under the Programs
<b>2006</b>				
July 1 to July 31	-	-	-	30,498
August 1 to August 31	-	-	-	30,498
September 1 to September 30	-	-	-	30,498
<b>Total</b>	-	-	-	

Compensation Plan Programs:

- A consolidated compensation plan share purchase program was approved on July 20, 2004, and was announced on August 6, 2004. This plan consolidated into a single share purchase program all of the previously authorized compensation plan share programs as well as the renewal of the authorization to purchase shares for use in connection with two compensation plans for which the share purchase authority had expired. The total amount originally authorized under this consolidated compensation plan share purchase program is 25.1 million shares. On April 24, 2006, an increase to the authority under this purchase program of 4.5 million shares was announced for a new total authorization of 29.6 million shares. The shares may be purchased over the option exercise period of the various compensation plans on or before December 31, 2023. Stock options granted after January 2, 2004, must be exercised no later than the tenth anniversary of the grant date. On September 30, 2006, the maximum number of shares that may yet be purchased under the program was 28.8 million shares.

Other Programs:

- A non-stock option plan-related authority was announced on October 18, 2000, authorizing the purchase of up to 9.5 million shares. On October 16, 2001, it was announced that FHN's board of directors extended the expiration date of this program from June 30, 2002, until December 31, 2004. On October 19, 2004, the board of directors extended the authorization until December 31, 2007. On September 30, 2006, the maximum number of shares that may yet be purchased under the program was 1.7 million shares.

Banking regulators define minimum capital ratios for bank holding companies and their bank subsidiaries. Based on the capital rules and definitions prescribed by the banking regulators, should any depository institution's capital ratios decline below predetermined levels, it would become subject to a series of increasingly restrictive regulatory actions. The system categorizes a depository institution's capital position into one of five categories ranging from well-capitalized to critically under-capitalized. For an institution to qualify as well-capitalized, Tier 1 Capital, Total Capital and Leverage capital ratios must be at least 6 percent, 10 percent and 5 percent, respectively. As of September 30, 2006, FHN and FTBNA had sufficient capital to qualify as well-capitalized institutions as shown in Note 7 - Regulatory Capital.

## **RISK MANAGEMENT**

FHN has an enterprise-wide approach to risk governance, measurement, management, and reporting including an economic capital allocation process that is tied to risk profiles used to measure risk-adjusted returns. The Enterprise-wide Risk/Return Management Committee oversees risk management governance. Committee membership includes the CEO and other executive officers of FHN. The Executive Vice President (EVP) of Risk Management oversees reporting for the committee. Risk management objectives include evaluating risks inherent in business strategies, monitoring proper balance of risks and returns, and managing risks to minimize the probability of future negative outcomes. The Enterprise-wide Risk/Return Management Committee oversees and receives regular reports from the Senior Credit Policy Committee, Asset/Liability Committee (ALCO), Capital Management Committee and Operational Risk Committee. The Chief Credit Officer, EVP of Interest Rate Risk Management, Chief Financial Officer and EVP of Risk Management chair these committees respectively. Reports regarding Credit, Asset/Liability, Market, Capital Management and Operational Risks are provided to the Credit Policy and Executive and/or Audit Committee of the Board and to the full Board.

Risk management practices include key elements such as independent checks and balances, formal authority limits, policies and procedures, and portfolio management all executed through experienced personnel. The internal audit department also evaluates risk

management activities. These activities include performing internal audits, the results of which are reviewed with management and the Audit Committee, as appropriate.

### **INTEREST RATE RISK MANAGEMENT**

Interest rate sensitivity risk is defined as the risk that future changes in interest rates will adversely impact income. The primary objective of managing interest rate risk is to minimize the volatility to earnings from changes in interest rates and preserve the value of FHN's capital. ALCO, a committee consisting of senior management that meets regularly, is responsible for coordinating the financial management of interest rate risk. FHN primarily manages interest rate risk by structuring the balance sheet to attempt to maintain the desired level of net interest income while managing interest rate risk and liquidity.

Net interest income and the financial condition of FHN are affected by changes in the level of market interest rates as the repricing characteristics of its loans and other assets do not necessarily match those of its deposits, other borrowings and capital. To the extent that earning assets reprice more quickly than liabilities, this position will benefit net interest income in a rising interest rate environment and will negatively impact net interest income in a declining interest rate environment. In the case of floating-rate assets and liabilities, FHN may also be exposed to basis risk, which results from changing spreads between loan and deposit rates. Generally, when interest rates decline Mortgage Banking faces increased prepayment risk associated with its MSR.

In certain cases, derivative financial instruments are used to aid in managing the exposure of the balance sheet and related net interest income and noninterest income to changes in interest rates. For example, Mortgage Banking uses derivatives to protect against MSR prepayment risk and against changes in fair value of the mortgage pipeline and warehouse. Capital Markets uses derivatives to protect against the risk of loss arising from adverse changes in the fair value of its inventory due to changes in interest rates. The prepayment risk in the loan portfolio is not hedged with derivatives or otherwise.

In addition to the balance sheet impacts, fee income and noninterest expense may be affected by actual changes in interest rates or expectations of changes. Mortgage banking revenue, which is generated from originating, selling and servicing residential mortgage loans, is highly sensitive to changes in interest rates due to the direct effect changes in interest rates have on loan demand. In general, low or declining interest rates typically lead to increased origination fees and profit from the sale of loans but potentially lower servicing-related income due to the impact of higher loan prepayments on the value of mortgage servicing assets. Conversely, high or rising interest rates typically reduce mortgage loan demand and hence income from originations and sales of loans while servicing-related income may rise due to lower prepayments. The earnings impact from originations and sales of loans on total earnings is more significant than servicing-related income. Net interest income earned on warehouse loans held for sale and on swaps and similar derivative instruments used to protect the value of MSR increases when the yield curve steepens and decreases when the yield curve flattens. In addition, a flattening yield curve typically negatively impacts the demand for fixed income securities and, therefore, Capital Markets' revenue, as well as trading inventory spreads.

### **LIQUIDITY MANAGEMENT**

ALCO focuses on being able to fund assets with liabilities of the appropriate duration, as well as the risk of not being able to meet unexpected cash needs. The objective of liquidity management is to ensure the continuous availability of funds to meet the demands of depositors, other creditors and borrowers, and the requirements of ongoing operations. This objective is met by maintaining liquid assets in the form of trading securities and securities available for sale, maintaining sufficient unused borrowing capacity in the national money markets, growing core deposits, and the repayment of loans and the capability to sell or securitize loans. ALCO is responsible for managing these needs by taking into account the marketability of assets; the sources, stability and availability of funding; and the level of unfunded commitments. Funds are available from a number of sources, including core deposits, the securities available for sale portfolio, the Federal Home Loan Bank, the Federal Reserve Banks, access to capital markets

through issuance of senior or subordinated bank notes and institutional certificates of deposit, availability to the overnight and term Federal Funds markets, access to retail brokered certificates of deposit, dealer and commercial customer repurchase agreements, and through the sale or securitization of loans.

Core deposits are a significant source of funding and have been a stable source of liquidity for banks. The Federal Deposit Insurance Corporation insures these deposits to the extent authorized by law. For third quarter 2006 and 2005, the total loans, excluding loans held for sale and real estate loans pledged against other collateralized borrowings, to core deposits ratio was 162 percent and 150 percent, respectively. As loan growth currently exceeds core deposit growth, alternative sources of funding loan growth may be necessary in order to maintain an adequate liquidity position. One means of maintaining a stable liquidity position is to sell loans either through whole-loan sales or loan securitizations. During first quarter 2006, FHN sold loans through an on-balance sheet securitization, which is structured as a

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financing for accounting purposes. FHN periodically evaluates its liquidity position in conjunction with determining its ability and intent to hold loans for the foreseeable future.

FTBNA also has the ability to enhance its liquidity position by issuing preferred equity or incurring other debt. FHN also evaluates alternative sources of funding, including loan sales, securitizations, syndications, Federal Home Loan Bank borrowings, debt offerings and equity offerings in its management of liquidity.

FTBNA has a bank note program providing additional liquidity of \$5.0 billion. This bank note program provides FTBNA with a facility under which it may continuously issue and offer short- and medium-term unsecured notes. On September 30, 2006, \$2.6 billion was available under current conditions through the bank note program as a funding source.

Liquidity has also been obtained through FTBNA's issuance of 300,000 shares of noncumulative perpetual preferred stock which provided approximately \$295 million additional capital. In addition, liquidity has been obtained through issuance of \$300.0 million of guaranteed preferred beneficial interests in FHN's junior subordinated debentures through two Delaware business trusts wholly owned by FHN and through preferred stock issued by an indirect wholly-owned subsidiary of FHN (\$45.3 million on September 30, 2006).

The Consolidated Condensed Statements of Cash Flows provide information on cash flows from operating, investing and financing activities for the nine-month periods ended September 30, 2006 and 2005. Net cash provided by financing activities was the primary contributor to an increase in cash and cash equivalents for both nine-month periods ended September 30, 2006 and 2005. Growth in deposits and the issuance of long-term borrowings provided positive cash flow from financing activities in 2006 and were utilized to fund the balance sheet growth reflected in the net cash used by investing activities. The cash flows from the merchant divestiture, which was accounted for as a discontinued operation, are included in the consolidated results. The sale resulted in a \$421.8 million increase in cash and cash equivalents, of which \$208.6 million, the gain on the sale, is included in net income. The divestiture of merchant operations is not expected to have a material impact on future liquidity. For the nine months ended September 30, 2006, significant cash flows from investing activities included the sale of \$2.3 billion investment securities and the subsequent purchase of \$3.8 billion investment securities as the portfolio was repositioned in response to the current interest rate environment. Cash outflows for investing activities also included \$1.5 billion due to loan growth. Growth in deposits provided positive cash flows from financing activities in 2005, and these funds were utilized to meet the liquidity needs related to strong loan growth and the acquisition of the fixed income business of Spear, Leeds and Kellogg that was reflected in negative cash flows from investing activities. Earnings represent a significant source of liquidity, consistently providing positive cash flows from operating activities in the nine-month periods ended September 30, 2006 and 2005.

Parent company liquidity is maintained by cash flows from dividends and interest payments collected from subsidiaries, which represent the primary source of funds to pay dividends to shareholders and interest to debt holders. The parent company also has the ability to enhance its liquidity position by raising equity or incurring debt. Under an effective shelf registration statement on file with the SEC, FHN, as of September 30, 2006, may offer from time to time at its discretion, debt securities, and common and preferred stock aggregating up to \$125 million. In addition, \$50 million of borrowings under unsecured lines of credit from non-affiliated banks were available to the parent company to provide for general liquidity needs.

#### **OFF-BALANCE SHEET ARRANGEMENTS AND OTHER CONTRACTUAL OBLIGATIONS**

First Horizon Home Loans originates conventional conforming and federally insured single-family residential mortgage loans. Likewise, FTN Financial Capital Assets Corporation purchases the same types of loans from customers. Substantially all of these mortgage loans are exchanged for securities, which are issued through investors, including government-sponsored enterprises (GSE), such as Government National Mortgage Association (GNMA) for federally insured loans and Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) for conventional loans, and then sold in the secondary markets. Each of the GSE has specific guidelines and criteria for sellers and servicers of loans backing their respective securities. Many private investors are also active in the secondary market as issuers and investors. The risk of credit loss with regard to the principal amount of the loans sold is generally transferred to investors upon sale to the secondary market. To the extent that transferred loans are subsequently determined not to meet the agreed upon qualifications or criteria, the purchaser has the right to return those loans to FHN. In addition, certain mortgage loans are sold to investors with limited or full recourse in the event of mortgage foreclosure (refer to discussion of foreclosure reserves under Critical Accounting Policies). After sale, these loans are not reflected on the Consolidated Condensed Statements of Condition.

FHN's use of government agencies as an efficient outlet for mortgage loan production is an essential source of liquidity for FHN and other participants in the housing industry. During third quarter 2006, \$3.3 billion of conventional and federally insured mortgage loans were securitized and sold by First Horizon Home Loans through these investors.

Certain of FHN's originated loans, including non-conforming first-lien mortgages, second-lien mortgages and HELOC originated primarily through FTBNA, do not conform to the requirements for sale or securitization through government agencies. FHN pools and securitizes

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these non-conforming loans in proprietary transactions. After securitization and sale, these loans are not reflected on the Consolidated Condensed Statements of Condition. These transactions, which are conducted through single-purpose business trusts, are the most efficient way for FHN and other participants in the housing industry to monetize these assets. On September 30, 2006, the outstanding principal amount of loans in these off-balance sheet business trusts was \$23.7 billion. Given the significance of FHN's origination of non-conforming loans, the use of single-purpose business trusts to securitize these loans is an important source of liquidity to FHN.

FHN has various other financial obligations, which may require future cash payments. Purchase obligations represent obligations under agreements to purchase goods or services that are enforceable and legally binding on FHN and that specify all significant terms, including fixed or minimum quantities to be purchased, fixed, minimum or variable price provisions, and the approximate timing of the transaction. In addition, FHN enters into commitments to extend credit to borrowers, including loan commitments, standby letters of credit, and commercial letters of credit. These commitments do not necessarily represent future cash requirements, in that these commitments often expire without being drawn upon.

#### **MARKET RISK MANAGEMENT**

Capital markets buys and sells various types of securities for its customers. When these securities settle on a delayed basis, they are considered forward contracts. Inventory positions are limited to the procurement of securities solely for distribution to customers by the sales staff, and ALCO policies and guidelines have been established with the objective of limiting the risk in managing this inventory.

### **CAPITAL MANAGEMENT**

The capital management objectives of FHN are to provide capital sufficient to cover the risks inherent in FHN's businesses, to maintain excess capital to well-capitalized standards and to assure ready access to the capital markets. Management has a Capital Management committee that is responsible for capital management oversight and provides a forum for addressing management issues related to capital adequacy. The committee reviews sources and uses of capital, key capital ratios, segment economic capital allocation methodologies, and other factors in monitoring and managing current capital levels, as well as potential future sources and uses of capital. The committee also recommends capital management policies, which are submitted for approval to the Enterprise-wide Risk/Return Management Committee and the Board.

### **CREDIT RISK MANAGEMENT**

Credit risk is the risk of loss due to adverse changes in a borrower's ability to meet its financial obligations under agreed upon terms. FHN is subject to credit risk in lending, trading, investing, liquidity/funding and asset management activities. The nature and amount of credit risk depends on the types of transactions, the structure of those transactions and the parties involved. In general, credit risk is incidental to trading, liquidity/funding and asset management activities, while it is central to the profit strategy in lending. As a result, the majority of credit risk is associated with lending activities.

FHN has processes and management committees in place that are designed to assess and monitor credit risks. Management's Asset Quality Committee has the responsibility to evaluate its assessment of current asset quality for each lending product. In addition, the Asset Quality Committee evaluates the projected changes in classified loans, non-performing assets and charge-offs. A primary objective of this committee is to provide information about changing trends in asset quality by region or loan product, and to provide to senior management a current assessment of credit quality as part of the estimation process for determining the allowance for loan losses. The Senior Credit Watch Committee has primary responsibility to enforce proper loan risk grading, to identify credit problems and to monitor actions to rehabilitate certain credits. Management also has a Senior Credit Policy Committee that is responsible for enterprise-wide credit risk oversight and provides a forum for addressing management issues. The committee also recommends credit policies, which are submitted for approval to the Credit Policy and Executive Committee of the Board, and underwriting guidelines to manage the level and composition of credit risk in its loan portfolio and review performance relative to these policies. In addition, the Financial Counterparty Credit Committee, composed of senior managers, assesses the credit risk of financial counterparties and sets limits for exposure based upon the credit quality of the counterparty. FHN's goal is to manage risk and price loan products based on risk management decisions and strategies. Management strives to identify potential problem loans and nonperforming loans early enough to correct the deficiencies. It is management's objective that both charge-offs and asset write-downs are recorded promptly, based on management's assessments of current collateral values and the borrower's ability to repay.

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### **OPERATIONAL RISK MANAGEMENT**

Operational risk is the risk of loss from inadequate or failed internal processes, people, and systems or from external events. This risk is inherent in all businesses. Management, measurement and reporting of operational risk are

overseen by the Operational Risk Committee, which is chaired by the EVP of Risk Management. Key representatives from the business segments, legal, shared services, risk management, and insurance are represented on the committee. Subcommittees manage and report on business continuity planning, information technology, data security, insurance, compliance, records management, product and system development, customer complaint, and reputation risks. Summary reports of the committee's activities and decisions are provided to the Enterprise-wide Risk/Return Management Committee. Emphasis is dedicated to refinement of processes and tools to aid in measuring and managing material operational risks and providing for a culture of awareness and accountability.

## **CRITICAL ACCOUNTING POLICIES**

### **APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

FHN's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. The consolidated condensed financial statements of FHN are prepared in conformity with accounting principles generally accepted in the United States of America and follow general practices within the industries in which it operates. The preparation of the financial statements requires management to make certain judgments and assumptions in determining accounting estimates. Accounting estimates are considered critical if (a) the estimate requires management to make assumptions about matters that were highly uncertain at the time the accounting estimate was made, and (b) different estimates reasonably could have been used in the current period, or changes in the accounting estimate are reasonably likely to occur from period to period, that would have a material impact on the presentation of FHN's financial condition, changes in financial condition or results of operations.

It is management's practice to discuss critical accounting policies with the Board of Directors' Audit Committee including the development, selection and disclosure of the critical accounting estimates. Management believes the following critical accounting policies are both important to the portrayal of the company's financial condition and results of operations and require subjective or complex judgments. These judgments about critical accounting estimates are based on information available as of the date of the financial statements.

Effective January 1, 2006, FHN elected early adoption of SFAS No. 156. This amendment to Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (SFAS No. 140) requires servicing rights be initially measured at fair value. Subsequently, companies are permitted to elect, on a class-by-class basis, either fair value or amortized cost accounting for servicing rights. FHN elected fair value accounting for all classes of mortgage servicing rights. Accordingly, FHN recognized the cumulative effect of a change in accounting principle totaling \$.2 million, net of tax, representing the excess of the fair value of the servicing asset over the recorded value on January 1, 2006.

### **MORTGAGE SERVICING RIGHTS AND OTHER RELATED RETAINED INTERESTS**

When FHN sells mortgage loans in the secondary market to investors, it generally retains the right to service the loans sold in exchange for a servicing fee that is collected over the life of the loan as the payments are received from the borrower. An amount is capitalized as MSR on the Consolidated Condensed Statements of Condition. In 2005 these amounts were included at the lower of cost, net of accumulated amortization, or fair value. The cost basis of MSR qualifying for SFAS No. 133 fair value hedge accounting was adjusted to reflect changes in fair value. With the adoption of SFAS No. 156 on January 1, 2006, these amounts are included at current fair value. The changes in carrying value of MSR are included as a component of Mortgage Banking - Noninterest Income on the Consolidated Condensed Statements of Income.

#### **MSR Estimated Fair Value**

The fair value of MSR typically rises as market interest rates increase and declines as market interest rates decrease; however, the extent to which this occurs depends in part on (1) the magnitude of changes in market interest rates, and (2) the differential between the then current market interest rates for mortgage loans and the mortgage interest rates included in the mortgage-servicing portfolio.

Since sales of MSR tend to occur in private transactions and the precise terms and conditions of the sales are typically not readily available, there is a limited market to refer to in determining the fair value of MSR. As such, like other participants in the mortgage banking business, FHN relies primarily on a discounted cash flow model to estimate the fair value of its MSR. This model calculates estimated fair value of the MSR using predominant risk characteristics of MSR, such as interest rates, type of product (fixed vs. variable), age (new, seasoned, moderate), agency type and other factors. FHN uses assumptions in the model that it believes are comparable to those used by other participants in the mortgage banking business and reviews estimated fair values and assumptions with third-party brokers and other service

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providers on a quarterly basis. FHN also compares its estimates of fair value and assumptions to recent market activity and against its own experience.

Estimating the cash flow components of net servicing income from the loan and the resultant fair value of the MSR requires FHN to make several critical assumptions based upon current market and loan production data.

**Prepayment Speeds:** Generally, when market interest rates decline and other factors favorable to prepayments occur there is a corresponding increase in prepayments as customers refinance existing mortgages under more favorable interest rate terms. When a mortgage loan is prepaid the anticipated cash flows associated with servicing that loan are terminated, resulting in a reduction of the fair value of the capitalized MSR. To the extent that actual borrower prepayments do not react as anticipated by the prepayment model (i.e., the historical data observed in the model does not correspond to actual market activity), it is possible that the prepayment model could fail to accurately predict mortgage prepayments and could result in significant earnings volatility. To estimate prepayment speeds, First Horizon Home Loans utilizes a third-party prepayment model, which is based upon statistically derived data linked to certain key principal indicators involving historical borrower prepayment activity associated with mortgage loans in the secondary market, current market interest rates and other factors, including First Horizon Home Loans' own historical prepayment experience. For purposes of model valuation, estimates are made for each product type within the MSR portfolio on a monthly basis.

#### Table 8 - Mortgage Banking Prepayment Assumptions

	Three Months Ended September 30	
	2006	2005
Prepayment speeds		
Actual	16.8%	29.0%
Estimated*	15.0	25.7

\* Estimated prepayment speeds represent monthly average prepayment speed estimates for each of the periods presented.

**Discount Rate:** Represents the rate at which expected cash flows are discounted to arrive at the net present value of servicing income. Discount rates will change with market conditions (i.e., supply vs. demand) and be reflective of the yields expected to be earned by market participants investing in MSR.

**Cost to Service:** Expected costs to service are estimated based upon the incremental costs that a market participant would use in evaluating the potential acquisition of MSR.

**Float Income:** Estimated float income is driven by expected float balances (principal, interest and escrow payments that are held pending remittance to the investor or other third party) and current market interest rates, including the



thirty-day London Inter-Bank Offered Rate (LIBOR) and five-year swap interest rates, which are updated on a monthly basis for purposes of estimating the fair value of MSR.

First Horizon Home Loans engages in a process referred to as “price discovery” on a quarterly basis to assess the reasonableness of the estimated fair value of MSR. Price discovery is conducted through a process of obtaining the following information: (a) quarterly informal (and an annual formal) valuation of the servicing portfolio by an independent third party: a prominent mortgage-servicing broker, and (b) a collection of surveys and benchmarking data made available by independent third parties that include peer participants in the mortgage banking business. Although there is no single source of market information that can be relied upon to assess the fair value of MSR, First Horizon Home Loans reviews all information obtained during price discovery to determine whether the estimated fair value of MSR is reasonable when compared to market information. On September 30, 2006 and 2005, First Horizon Home Loans determined that its MSR valuations and assumptions were reasonable based on the price discovery process.

The First Horizon Risk Management Committee (FHRMC) submits the overall assessment of the estimated fair value of MSR monthly for review. The FHRMC is responsible for approving the critical assumptions used by management to determine the estimated fair value of First Horizon Home Loans’ MSR. Each quarter, FHN’s MSR Committee reviews the initial capitalization rates for newly originated MSR, the current valuation of MSR and the source of significant changes to the MSR carrying value.

#### **Hedging the Fair Value of MSR**

First Horizon Home Loans enters into financial agreements to hedge MSR in order to minimize the effects of loss in value of MSR associated with increased prepayment activity that generally results from declining interest rates. In a rising interest rate environment, the value of the MSR generally will increase while the value of the hedge instruments will decline. Specifically, First Horizon Home Loans enters into interest

rate contracts (including swaps, swaptions and mortgage forward sales contracts) to hedge against the effects of changes in fair value of its MSR. Substantially all capitalized MSR are hedged for economic purposes.

Prior to the adoption of SFAS No. 156, First Horizon Home Loans hedged the changes in MSR value attributable to changes in the benchmark interest rate (10-year LIBOR swap rate). The vast majority of MSR routinely qualified for hedge accounting. For purposes of measuring effectiveness of the hedge, time decay and recognized net interest income, including changes in value attributable to changes in spot and forward prices, if applicable, were excluded from the change in value of the related derivatives. Interest rate derivative contracts used to hedge against interest rate risk in the servicing portfolio were designated to specific risk tranches of servicing. Hedges were reset at least monthly and more frequently, as needed, to respond to changes in interest rates or hedge composition. Generally, a coverage ratio approximating 100 percent was maintained on hedged MSR. Prior to acquiring a new hedge instrument, First Horizon Home Loans performed a prospective evaluation of anticipated hedge effectiveness by reviewing the historical regression between the underlying index of the proposed hedge instrument and the mortgage rate. At the end of each hedge period, the change in the fair value of the hedged MSR asset due to the change in benchmark interest rate was calculated and became a historical data point. Retrospective hedge effectiveness was determined by performing a regression analysis of all collected data points over a rolling 12-month period. Effective hedging under SFAS No. 133 resulted in adjustments to the recorded value of the MSR. These basis adjustments, as well as the change in fair value of derivatives attributable to effective hedging, were included as a component of servicing income in mortgage banking noninterest income.

MSR subject to SFAS No. 133 hedges totaled \$1.2 billion on September 30, 2005. Related derivative net assets were \$4.5 million on September 30, 2005. Pursuant to SFAS No. 133, the basis in MSR that qualified for hedge accounting was adjusted for the impact of hedge performance in net servicing income. Included in servicing income in mortgage

banking noninterest income for third quarter 2005 was a net loss of \$8.2 million, representing fair value hedge ineffectiveness and a net loss of \$5.2 million, representing derivative gains from net interest income on swaps, net of time decay, which was excluded from the assessment of hedge effectiveness.

With the adoption of SFAS No. 156, First Horizon Home Loans no longer evaluates prospective or retrospective hedge performance for qualification as a SFAS No. 133 hedge. The hedges are economic hedges only, and are terminated and reestablished as needed to respond to changes in market conditions. Changes in the value of the hedges continue to be recognized as a component of net servicing income in mortgage banking noninterest income. Successful economic hedging will help minimize earnings volatility that may result when carrying MSR at fair value.

First Horizon Home Loans generally experiences increased loan origination and production in periods of low interest rates which, at the time of sale, result in the capitalization of new MSR associated with new production. This provides for a "natural hedge" in the mortgage-banking business cycle. New production and origination does not prevent First Horizon Home Loans from recognizing losses due to reduction in carrying value of existing servicing rights as a result of prepayments; rather, the new production volume results in loan origination fees and the capitalization of MSR as a component of realized gains related to the sale of such loans in the secondary market, thus the natural hedge, which tends to offset a portion of the reduction in MSR carrying value during a period of low interest rates. In a period of increased borrower prepayments, these losses can be significantly offset by a strong replenishment rate and strong net margins on new loan originations. To the extent that First Horizon Home Loans is unable to maintain a strong replenishment rate, or in the event that the net margin on new loan originations declines from historical experience, the value of the natural hedge may diminish, thereby significantly impacting the results of operations in a period of increased borrower prepayments.

First Horizon Home Loans does not specifically hedge the change in fair value of MSR attributed to other risks, including unanticipated prepayments (representing the difference between actual prepayment experience and estimated prepayments derived from the model, as described above), basis risk (meaning, the risk that changes in the benchmark interest rate may not correlate to changes in the mortgage market interest rate), discount rates, cost to service and other factors. To the extent that these other factors result in changes to the fair value of MSR, First Horizon Home Loans experiences volatility in current earnings due to the fact that these risks are not currently hedged.

#### **Excess Interest (Interest-Only Strips) Fair Value - Residential Mortgage Loans**

In certain cases, when First Horizon Home Loans sells mortgage loans in the secondary market, it retains an interest in the mortgage loans sold primarily through excess interest. These financial assets represent rights to receive earnings from serviced assets that exceed contractually specified servicing fees. Consistent with MSR, the fair value of excess interest typically rises as market interest rates increase and declines as market interest rates decrease. Additionally, similar to MSR, the market for excess interest is limited, and the precise terms of transactions involving excess interest are not typically readily available. Accordingly, First Horizon Home Loans relies primarily on a discounted cash flow model to estimate the fair value of its excess interest.

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Estimating the cash flow components and the resultant fair value of the excess interest requires First Horizon Home Loans to make certain critical assumptions based upon current market and loan production data. The primary critical assumptions used by First Horizon Home Loans to estimate the fair value of excess interest include prepayment speeds and discount rates, as discussed above. First Horizon Home Loans' excess interest is included as a component of trading securities on the Consolidated Condensed Statements of Condition, with realized and unrealized gains and losses included in current earnings as a component of mortgage banking income on the Consolidated Condensed Statements of Income.

#### **Hedging the Fair Value of Excess Interest**

First Horizon Home Loans utilizes derivatives (including swaps, swaptions and mortgage forward sales contracts) that change in value inversely to the movement of interest rates to protect the value of its excess interest as an economic hedge. Realized and unrealized gains and losses associated with the change in fair value of derivatives used in the economic hedge of excess interest are included in current earnings in mortgage banking noninterest income as a component of servicing income. Excess interest is included in trading securities with changes in fair value recognized currently in earnings in mortgage banking noninterest income as a component of servicing income.

The extent to which the change in fair value of excess interest is offset by the change in fair value of the derivatives used to hedge this asset depends primarily on the hedge coverage ratio maintained by First Horizon Home Loans. Also, as noted above, to the extent that actual borrower prepayments do not react as anticipated by the prepayment model (i.e., the historical data observed in the model does not correspond to actual market activity), it is possible that the prepayment model could fail to accurately predict mortgage prepayments, which could significantly impact First Horizon Home Loans' ability to effectively hedge certain components of the change in fair value of excess interest and could result in significant earnings volatility.

### **Residual-Interest Certificates Fair Value - HELOC and Second-lien Mortgages**

In certain cases, when FHN sells HELOC or second-lien mortgages in the secondary market, it retains an interest in the loans sold primarily through a residual-interest certificate. Residual-interest certificates are financial assets which represent rights to receive earnings to the extent of excess income generated by the underlying loan collateral of certain mortgage-backed securities, which is not needed to meet contractual obligations of senior security holders. The fair value of a residual-interest certificate typically changes based on the differences between modeled prepayment speeds and credit losses and actual experience. Additionally, similar to MSR and interest-only certificates, the market for residual-interest certificates is limited, and the precise terms of transactions involving residual-interest certificates are not typically readily available. Accordingly, FHN relies primarily on a discounted cash flow model, which is prepared monthly, to estimate the fair value of its residual-interest certificates.

Estimating the cash flow components and the resultant fair value of the residual-interest certificates requires FHN to make certain critical assumptions based upon current market and loan production data. The primary critical assumptions used by FHN to estimate the fair value of residual-interest certificates include prepayment speeds, credit losses and discount rates, as discussed above. FHN's residual-interest certificates are included as a component of trading securities on the Consolidated Condensed Statements of Condition, with realized and unrealized gains and losses included in current earnings as a component of other income on the Consolidated Condensed Statements of Income. FHN does not utilize derivatives to hedge against changes in the fair value of residual-interest certificates.

### **PIPELINE AND WAREHOUSE**

During the period of loan origination and prior to the sale of mortgage loans in the secondary market, First Horizon Home Loans has exposure to mortgage loans that are in the "mortgage pipeline" and the "mortgage warehouse". The mortgage pipeline consists of loan applications that have been received, but have not yet closed as loans. Pipeline loans are either "floating" or "locked". A floating pipeline loan is one on which an interest rate has not been locked by the borrower. A locked pipeline loan is one on which the potential borrower has set the interest rate for the loan by entering into an interest rate lock commitment resulting in interest rate risk to First Horizon Home Loans. Once a mortgage loan is closed and funded, it is included within the mortgage warehouse, or the "inventory" of mortgage loans that are awaiting sale and delivery (currently an average of approximately 30 days) into the secondary market. First Horizon Home Loans is exposed to credit risk while a mortgage loan is in the warehouse. Third party models are used in managing interest rate risk related to price movements on loans in the pipeline and the warehouse.

First Horizon Home Loans' warehouse (first-lien mortgage loans held for sale) is subject to changes in fair value, primarily due to fluctuations in interest rates from the loan closing date through the date of sale of the loan into the secondary market. Typically, the fair value of the warehouse declines in value when interest rates increase and rises in value when interest rates decrease. To mitigate this risk, First Horizon Home Loans enters into forward sales contracts and futures contracts to provide an economic hedge against those changes in fair value on a significant portion of the

warehouse. These derivatives are recorded at fair value with changes in fair value recorded in current earnings as a component of the gain or loss on the sale of loans in mortgage banking noninterest income.

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To the extent that these interest rate derivatives are designated to hedge specific similar assets in the warehouse and prospective analyses indicate that high correlation is expected, the hedged loans are considered for hedge accounting under SFAS No. 133. Anticipated correlation is determined based on the historical regressions between the change in fair value of the derivatives and the change in fair value of hedged mortgage loans. Beginning in fourth quarter 2005, anticipated correlation is determined by projecting a dollar offset relationship for each tranche based on anticipated changes in the fair value of the hedged mortgage loans and the related derivatives, in response to various interest rate shock scenarios. Hedges are reset daily and the statistical correlation is calculated using these daily data points. Retrospective hedge effectiveness is measured using the regression results. First Horizon Home Loans generally maintains a coverage ratio (the ratio of expected change in the fair value of derivatives to expected change in the fair value of hedged assets) of approximately 100 percent on warehouse loans accounted for under SFAS No. 133.

Warehouse loans qualifying for SFAS No. 133 hedge accounting treatment totaled \$1.0 billion and \$.5 billion on September 30, 2006 and 2005, respectively. The balance sheet impacts of the related derivatives were net liabilities of \$5.7 million on September 30, 2006, and net assets of \$2.1 million on September 30, 2005. For third quarter 2006, net losses of \$1.0 million compared to net gains of \$.4 million for third quarter 2005, representing the hedge ineffectiveness of these fair value hedges, were recognized as a component of gain or loss on sale of loans.

Mortgage banking interest rate lock commitments are short-term commitments to fund mortgage loan applications in process (the pipeline) for a fixed term at a fixed price. During the term of an interest rate lock commitment, First Horizon Home Loans has the risk that interest rates will change from the rate quoted to the borrower. First Horizon Home Loans enters into forward sales contracts with respect to fixed rate loan commitments and futures contracts with respect to adjustable rate loan commitments as economic hedges designed to protect the value of the interest rate lock commitment from changes in value due to changes in interest rates. Under SFAS No. 133 interest rate lock commitments qualify as derivative financial instruments and as such do not qualify for hedge accounting treatment. As a result, the interest rate lock commitments are recorded at fair value with changes in fair value recorded in current earnings as gain or loss on the sale of loans in mortgage banking noninterest income. Interest rate lock commitments generally have a term of up to 60 days before the closing of the loan. The interest rate lock commitment, however, does not bind the potential borrower to entering into the loan, nor does it guarantee that First Horizon Home Loans will approve the potential borrower for the loan. Therefore, First Horizon Home Loans makes estimates of expected "fallout" (locked pipeline loans not expected to close), using models, which consider cumulative historical fallout rates and other factors. Fallout can occur for a variety of reasons including falling rate environments when a borrower will abandon an interest rate lock commitment at one lender and enter into a new lower interest rate lock commitment at another, when a borrower is not approved as an acceptable credit by the lender, or for a variety of other non-economic reasons. Note that once a loan is closed, the risk of fallout is eliminated and the associated mortgage loan is included in the mortgage loan warehouse.

The extent to which First Horizon Home Loans is able to economically hedge changes in the mortgage pipeline depends largely on the hedge coverage ratio that is maintained relative to mortgage loans in the pipeline. The hedge coverage ratio can change significantly due to changes in market interest rates and the associated forward commitment prices for sales of mortgage loans in the secondary market. Increases or decreases in the hedge coverage ratio can result in significant earnings volatility to FHN.

For the periods ended September 30, 2006 and 2005, the valuation model utilized to estimate the fair value of interest rate lock commitments assumes a zero fair value on the date of the lock with the borrower. Subsequent to the lock date, the model calculates the change in value due solely to the change in interest rates resulting in a net asset with an estimated fair value of \$18.4 million on September 30, 2006, and a net liability with an estimated fair value of \$7.8

million on September 30, 2005.

### **FORECLOSURE RESERVES**

As discussed above, First Horizon Home Loans typically originates mortgage loans with the intent to sell those loans to GSE and other private investors in the secondary market. Certain of the mortgage loans are sold with limited or full recourse in the event of foreclosure. On September 30, 2006 and 2005, \$3.0 billion and \$3.2 billion, respectively, of mortgage loans were outstanding which were sold under limited recourse arrangements where some portion of the principal is at risk. Additionally, on September 30, 2006 and 2005, \$5.1 billion and \$6.0 billion, respectively, of mortgage loans were outstanding which were sold under limited recourse arrangements where the risk is limited to interest and servicing advances. On September 30, 2006 and 2005, \$130.4 million and \$165.1 million, respectively, of mortgage loans were outstanding which were serviced under full recourse arrangements.

Loans sold with limited recourse include loans sold under government guaranteed mortgage loan programs including the Federal Housing Administration (FHA) and Veterans Administration (VA). First Horizon Home Loans continues to absorb losses due to uncollected interest and foreclosure costs and/or limited risk of credit losses in the event of foreclosure of the mortgage loan sold. Generally, the amount of recourse liability in the event of foreclosure is determined based upon the respective government program and/or the sale or disposal of the foreclosed property collateralizing the mortgage loan. Another instance of limited recourse is the VA/No bid. In this case, the VA guarantee

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is limited and First Horizon Home Loans may be required to fund any deficiency in excess of the VA guarantee if the loan goes to foreclosure.

Loans sold with full recourse generally include mortgage loans sold to investors in the secondary market which are uninsurable under government guaranteed mortgage loan programs, due to issues associated with underwriting activities, documentation or other concerns.

Management closely monitors historical experience, borrower payment activity, current economic trends and other risk factors, and establishes a reserve for foreclosure losses for loans sold with limited recourse, loans serviced with full recourse, and loans sold with general representations and warranties, including early payment defaults. Management believes the foreclosure reserve is sufficient to cover incurred foreclosure losses relating to loans being serviced as well as loans sold where the servicing was not retained. The reserve for foreclosure losses is based upon a historical progression model using a rolling 12-month average, which predicts the probability or frequency of a mortgage loan entering foreclosure. In addition, other factors are considered, including qualitative and quantitative factors (e.g., current economic conditions, past collection experience, risk characteristics of the current portfolio and other factors), which are not defined by historical loss trends or severity of losses. On September 30, 2006 and 2005, the foreclosure reserve was \$14.8 million and \$16.8 million, respectively. The decrease in the foreclosure reserve is attributable to the decline in the limited and full recourse portfolios. This decrease was partially offset by increased reserves for loans sold with recourse for early payment default. The servicing portfolio has grown from \$93.6 billion on September 30, 2005, to \$100.6 billion on September 30, 2006.

### **ALLOWANCE FOR LOAN LOSSES**

Management's policy is to maintain the allowance for loan losses at a level sufficient to absorb estimated probable incurred losses in the loan portfolio. Management performs periodic and systematic detailed reviews of its loan portfolio to identify trends and to assess the overall collectibility of the loan portfolio. Accounting standards require that loan losses be recorded when management determines it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. Management believes the accounting estimate related to the allowance for loan losses is a "critical accounting estimate" because: changes in it can materially affect the provision for loan losses and net income, it requires management to predict borrowers' likelihood or capacity to repay, and it requires

management to distinguish between losses incurred as of a balance sheet date and losses expected to be incurred in the future. Accordingly, this is a highly subjective process and requires significant judgment since it is often difficult to determine when specific loss events may actually occur. The allowance for loan losses is increased by the provision for loan losses and recoveries and is decreased by charged-off loans. This critical accounting estimate applies primarily to the Retail/Commercial Banking segment. The Credit Policy and Executive Committee of FHN's board of directors reviews quarterly the level of the allowance for loan losses.

FHN's methodology for estimating the allowance for loan losses is not only critical to the accounting estimate, but to the credit risk management function as well. Key components of the estimation process are as follows: (1) commercial loans determined by management to be individually impaired loans are evaluated individually and specific reserves are determined based on the difference between the outstanding loan amount and the estimated net realizable value of the collateral (if collateral dependent) or the present value of expected future cash flows; (2) individual commercial loans not considered to be individually impaired are segmented based on similar credit risk characteristics and evaluated on a pool basis; (3) retail loans are segmented based on loan types and credit score bands and loan to value; (4) reserve rates for each portfolio segment are calculated based on historical charge-offs and are adjusted by management to reflect current events, trends and conditions (including economic factors and trends); and (5) management's estimate of probable incurred losses reflects the reserve rate applied against the balance of loans in each segment of the loan portfolio.

Principal loan amounts are charged off against the allowance for loan losses in the period in which the loan or any portion of the loan is deemed to be uncollectible.

FHN believes that the critical assumptions underlying the accounting estimate made by management include: (1) the commercial loan portfolio has been properly risk graded based on information about borrowers in specific industries and specific issues with respect to single borrowers; (2) borrower specific information made available to FHN is current and accurate; (3) the loan portfolio has been segmented properly and individual loans have similar credit risk characteristics and will behave similarly; (4) known significant loss events that have occurred were considered by management at the time of assessing the adequacy of the allowance for loan losses; (5) the economic factors utilized in the allowance for loan losses estimate are used as a measure of actual incurred losses; (6) the period of history used for historical loss factors is indicative of the current environment; and (7) the reserve rates, as well as other adjustments estimated by management for current events, trends, and conditions, utilized in the process reflect an estimate of losses that have been incurred as of the date of the financial statements.

While management uses the best information available to establish the allowance for loan losses, future adjustments to the allowance for loan losses and methodology may be necessary if economic or other conditions differ substantially from the assumptions used in making the

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estimates or, if required by regulators, based upon information at the time of their examinations. Such adjustments to original estimates, as necessary, are made in the period in which these factors and other relevant considerations indicate that loss levels vary from previous estimates. There have been no significant changes to the methodology for the quarters ended September 30, 2006 and 2005.

#### **GOODWILL AND ASSESSMENT OF IMPAIRMENT**

FHN's policy is to assess goodwill for impairment at the reporting unit level on an annual basis or between annual assessments if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. Accounting standards require management to estimate the fair value of each reporting unit in making the assessment of impairment at least annually. As of October 1, 2005, FHN engaged an independent valuation firm to compute the fair value estimates of each reporting unit as part of its annual impairment

assessment. The independent valuation utilized three separate valuation methodologies and applied a weighted average to each methodology in order to determine fair value for each reporting unit. The valuation as of October 1, 2005, indicated no goodwill impairment for any of the reporting units.

Management believes the accounting estimates associated with determining fair value as part of the goodwill impairment test is a "critical accounting estimate" because estimates and assumptions are made about FHN's future performance and cash flows, as well as other prevailing market factors (interest rates, economic trends, etc.). FHN's policy allows management to make the determination of fair value using internal cash flow models or by engaging independent third parties. If a charge to operations for impairment results, this amount would be reported separately as a component of noninterest expense. This critical accounting estimate applies to the Retail/Commercial Banking, Mortgage Banking, and Capital Markets business segments. Reporting units have been defined as the same level as the operating business segments.

The impairment testing process conducted by FHN begins by assigning net assets and goodwill to each reporting unit. FHN then completes "step one" of the impairment test by comparing the fair value of each reporting unit (as determined based on the discussion below) with the recorded book value (or "carrying amount") of its net assets, with goodwill included in the computation of the carrying amount. If the fair value of a reporting unit exceeds its carrying amount, goodwill of that reporting unit is not considered impaired, and "step two" of the impairment test is not necessary. If the carrying amount of a reporting unit exceeds its fair value, step two of the impairment test is performed to determine the amount of impairment. Step two of the impairment test compares the carrying amount of the reporting unit's goodwill to the "implied fair value" of that goodwill. The implied fair value of goodwill is computed by assuming all assets and liabilities of the reporting unit would be adjusted to the current fair value, with the offset as an adjustment to goodwill. This adjusted goodwill balance is the implied fair value used in step two. An impairment charge is recognized for the amount by which the carrying amount of goodwill exceeds its implied fair value.

In connection with obtaining the independent valuation, management provided certain data and information that was utilized by the third party in its determination of fair value. This information included budgeted and forecasted earnings of FHN at the reporting unit level. Management believes that this information is a critical assumption underlying the estimate of fair value. The independent third party made other assumptions critical to the process, including discount rates, asset and liability growth rates, and other income and expense estimates, through discussions with management.

While management uses the best information available to estimate future performance for each reporting unit, future adjustments to management's projections may be necessary if economic conditions differ substantially from the assumptions used in making the estimates.

### **CONTINGENT LIABILITIES**

A liability is contingent if the amount or outcome is not presently known, but may become known in the future as a result of the occurrence of some uncertain future event. FHN estimates its contingent liabilities based on management's estimates about the probability of outcomes and their ability to estimate the range of exposure. Accounting standards require that a liability be recorded if management determines that it is probable that a loss has occurred and the loss can be reasonably estimated. In addition, it must be probable that the loss will be confirmed by some future event. As part of the estimation process, management is required to make assumptions about matters that are by their nature highly uncertain.

The assessment of contingent liabilities, including legal contingencies and income tax liabilities, involves the use of critical estimates, assumptions and judgments. Management's estimates are based on their belief that future events will validate the current assumptions regarding the ultimate outcome of these exposures. However, there can be no assurance that future events, such as court decisions or I.R.S. positions, will not differ from management's assessments. Whenever practicable, management consults with third party experts (attorneys, accountants, claims administrators, etc.) to assist with the gathering and evaluation of information related to contingent liabilities.

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Based on internally and/or externally prepared evaluations, management makes a determination whether the potential exposure requires accrual in the financial statements.

## **OTHER**

### **ACCOUNTING CHANGES**

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Financial Instruments" (SFAS No. 155), which permits fair value remeasurement for hybrid financial instruments that contain an embedded derivative that otherwise would require bifurcation. Additionally, SFAS No. 155 clarifies the accounting guidance for beneficial interests in securitizations. Under SFAS No. 155, all beneficial interests in a securitization would require an assessment in accordance with SFAS No. 133 to determine if an embedded derivative exists within the instrument. SFAS No. 155 is effective for fiscal years beginning after September 15, 2006. FHN is currently assessing the financial impact of adopting SFAS No. 155.

In July 2006, FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48) was issued. FIN 48 provides guidance for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on the classification and disclosure of uncertain tax positions in the financial statements. Adoption of FIN 48 requires a cumulative effect adjustment to the beginning balance of retained earnings for differences between the tax benefits recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption. FIN 48 is effective for fiscal years beginning after December 15, 2006. FHN is continuing to assess the effects of FIN 48.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS No. 157), which establishes a hierarchy to be used in performing measurements of fair value. SFAS No. 157 emphasizes that fair value should be determined from the perspective of a market participant while also indicating that valuation methodologies should first reference available market data before using internally developed assumptions. Additionally, SFAS No. 157 provides expanded disclosure requirements about fair value measurement. SFAS No. 157 is effective prospectively for fiscal years beginning after November 15, 2007, with early adoption permitted for fiscal years in which financial statements have not been issued. FHN is currently assessing the financial impact of adopting SFAS No. 157.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)" (SFAS No. 158), which requires the recognition of the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in the statement of condition. SFAS No. 158 does not change measurement or recognition requirements for periodic pension and postretirement costs. SFAS No. 158 also provides that changes in the funded status of a defined benefit postretirement plan should be recognized in the year such changes occur through comprehensive income. Additionally, SFAS No. 158 requires that the annual measurement date of a plan's assets and liabilities be as of the date of the financial statements. Upon adoption of SFAS No. 158, unrecognized transition assets and obligations, unrecognized actuarial gains and losses, and unrecognized prior service costs and credits will be recognized as a component of accumulated other comprehensive income. SFAS No. 158 is effective for fiscal years ending after December 15, 2006, for funded status recognition and related disclosure requirements, with a one-time adjustment to the statement of condition. For measurement date requirements, SFAS No. 158 is effective for fiscal years ending after December 15, 2008. FHN expects a reduction in equity of between \$60 million and \$90 million upon adoption of SFAS No. 158.



In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB No. 108). SAB No. 108 requires that companies assess the impact on both the balance sheet and income statement when quantifying and evaluating the materiality of a misstatement. Under SAB No. 108, adjustment of financial statements is required when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors. Upon adoption, prior year errors, which had previously been considered immaterial but are considered material based on the guidance in SAB No. 108, should be recognized by either restating prior year financial statements or recording a one-time transitional cumulative effect adjustment to retained earnings. SAB No. 108 is effective for annual periods ending after November 15, 2006. FHN is currently assessing the guidance of SAB No. 108.

In September 2006, the consensus reached in EITF Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements" (EITF 06-4) was ratified by the FASB. EITF 06-4 requires that a liability be recognized for contracts written to employees which provide future postretirement benefits that are covered by endorsement split-dollar life insurance arrangements as such obligations are not effectively settled upon entering into the related insurance arrangements. EITF 06-4

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is effective for fiscal years beginning after December 15, 2007, with the guidance applied using either a retrospective approach or through a cumulative-effect adjustment to beginning retained earnings. FHN is currently assessing the financial impact of adopting EITF 06-4.

In September 2006, the consensus reached in EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance" (EITF 06-5) was ratified by the FASB. EITF 06-5 provides that in addition to the recognition of an asset for the amount that could be realized for a life insurance contract as of the balance sheet date, the amount recognized should also take into consideration certain other amounts included in a policy's contractual terms. Additionally, EITF 06-5 requires that the determination of the amount that could be realized under an insurance contract be performed at the individual policy level. EITF 06-5 is effective January 1, 2007, with the guidance applied using either a retrospective approach or through a cumulative-effect adjustment to beginning retained earnings. FHN does not anticipate that the effect of adopting EITF 06-5 will be material to its results of operations.

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### Item 3. Quantitative and Qualitative Disclosures about Market Risk

The information called for by this item is contained in (a) Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 2 of Part I of this report at pages 33-58, (b) the section entitled "Risk Management - Interest Rate Risk Management" of the Management's Discussion and Analysis of Results of Operations and Financial Condition section of FHN's 2005 Annual Report to shareholders, and (c) the "Interest Rate Risk Management" subsection of Note 1 to the Consolidated Financial Statements included in FHN's 2005 Annual Report to shareholders.

### Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures. FHN's management, with the participation of FHN's chief executive officer and chief financial officer, has evaluated the effectiveness of the design and operation of FHN's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this quarterly report. Based on that evaluation, the chief executive officer and chief financial officer

have concluded that FHN's disclosure controls and procedures are effective to ensure that material information relating to FHN and FHN's consolidated subsidiaries is made known to such officers by others within these entities, particularly during the period this quarterly report was prepared, in order to allow timely decisions regarding required disclosure.

(b) Changes in Internal Control over Financial Reporting. There have not been any changes in FHN's internal control over financial reporting during FHN's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, FHN's internal control over financial reporting.

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Part II.

OTHER INFORMATION

Items 1, 1A, 3, 4 and 5

As of the end of the third quarter 2006, the answers to Items 1, 1A, 3, 4 and 5 were either inapplicable or negative, and therefore, these items are omitted.

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

(a) None.

(b) Not applicable

(c) The Issuer Purchase of Equity Securities Table is incorporated herein by reference to the table included in Item 2 of Part I - First Horizon National Corporation - Management's Discussion and Analysis of Financial Condition and Results of Operations at page 46.

Item 6 Exhibits

(a) Exhibits.

<u>Exhibit No.</u>	<u>Description</u>
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3.2	Bylaws of the Corporation, as amended and restated as of October 18, 2006, incorporated herein by reference to Exhibit 3.2 to the Corporation's Current Report on Form 8-K dated October 18, 2006.
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4	Instruments defining the rights of security holders, including indentures.*
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10.4(e)**	Form of Notice of 2006 LTIP award, used for mid-year awards, under the 2003 Equity Compensation Plan, incorporated herein by reference to Exhibit 10.4(e) to the Corporation's Current Report on Form 8-K dated October 18, 2006.
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10.5(n)**	Sections of Director Policy pertaining to compensation and retirement, incorporated herein by reference to Exhibit 10.5(n) to the Corporation's Current Report on Form 8-K dated October 18, 2006.
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10.6(c)**	Capital Markets Incentive Compensation Plan, in which Mr. Mark Medford participates. Certain information in this exhibit has been omitted pursuant to a request for confidential treatment. The omitted information has been submitted separately to the Securities and Exchange Commission. In accordance with the Corporation's bylaws, the Corporation's Board Compensation Committee's charter, and action of that
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Committee on July 18, 2006, Mr. Medford's 2006 bonus will be subject to final review and approval by the Chief Operating Officer and the Compensation Committee.

10.8\*\* Survivor Benefits Plan, as amended and restated July 18, 2006.

10.19\*\* Form of Limited Confidentiality and Non-Compete Agreement with Mr. Jim L. Hughes, incorporated herein by reference to Exhibit 10.19 to the Corporation's Current Report on Form 8-K dated October 18, 2006.

10.20\*\* Description of 2006 salary rate for Mr. Mark Medford.

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13 The "Risk Management-Interest Rate Risk Management" subsection of the Management's Discussion and Analysis section and the "Interest Rate Risk Management" subsection of Note 25 to the Corporation's consolidated financial statements, contained, respectively, at pages 23-25 and page 107 in the Corporation's 2005 Annual Report to shareholders furnished to shareholders in connection with the Annual Meeting of Shareholders on April 18, 2006, and incorporated herein by reference. Portions of the Annual Report not incorporated herein by reference are deemed not to be "filed" with the Commission with this report.

31(a) Rule 13a-14(a) Certifications of CEO (pursuant to Section 302 of the Sarbanes-Oxley Act of 2002)

31(b) Rule 13a-14(a) Certifications of CFO (pursuant to Section 302 of the Sarbanes-Oxley Act of 2002)

32(a) 18 USC 1350 Certifications of CEO (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002)

32(b) 18 USC 1350 Certifications of CFO (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002)

\* The Corporation agrees to furnish copies of the instruments, including indentures, defining the rights of the holders of the long-term debt of the Corporation and its consolidated subsidiaries to the Securities and Exchange Commission upon request.

\*\* This is a management contract or compensatory plan required to be filed as an exhibit.

In many agreements filed as exhibits, each party makes representations and warranties to other parties. Those representations and warranties are made only to and for the benefit of those other parties in the context of a business contract. They are subject to contractual materiality standards. Exceptions to such representations and warranties may be partially or fully waived by such parties in their discretion. No such representation or warranty may be relied upon by any other person for any purpose.

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## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FIRST HORIZON NATIONAL CORPORATION  
(Registrant)

DATE: November 8, 2006

By: /s/ Marlin L. Mosby III  
 Marlin L. Mosby III  
 Executive Vice President and  
 Chief  
 Financial Officer (Duly  
 Authorized  
 Officer and Principal Financial  
 Officer)

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EXHIBIT INDEX

<u>Exhibit No.</u>	<u>Description</u>
3.2	Bylaws of the Corporation, as amended and restated as of October 18, 2006, incorporated herein by reference to Exhibit 3.2 to the Corporation's Current Report on Form 8-K dated October 18, 2006.
4	Instruments defining the rights of security holders, including indentures.*
10.4(e)**	Form of Notice of 2006 LTIP award, used for mid-year awards, under the 2003 Equity Compensation Plan, incorporated herein by reference to Exhibit 10.4(e) to the Corporation's Current Report on Form 8-K dated October 18, 2006.
10.5(n)**	Sections of Director Policy pertaining to compensation and retirement, incorporated herein by reference to Exhibit 10.5(n) to the Corporation's Current Report on Form 8-K dated October 18, 2006.
10.6(c)**	Capital Markets Incentive Compensation Plan, in which Mr. Mark Medford participates. Certain information in this exhibit has been omitted pursuant to a request for confidential treatment. The omitted information has been submitted separately to the Securities and Exchange Commission. In accordance with the Corporation's bylaws, the Corporation's Board Compensation Committee's charter, and action of that Committee on July 18, 2006, Mr. Medford's 2006 bonus will be subject to final review and approval by the Chief Operating Officer and the Compensation Committee.
10.8**	Survivor Benefits Plan, as amended and restated July 18, 2006.
10.19**	Form of Limited Confidentiality and Non-Compete Agreement with Mr. Jim L. Hughes, incorporated herein by reference to Exhibit 10.19 to the Corporation's Current Report on Form 8-K dated October 18, 2006.
10.20**	Description of 2006 salary rate for Mr. Mark Medford.
13	The "Risk Management-Interest Rate Risk Management" subsection of the Management's Discussion and Analysis section and the "Interest Rate Risk Management" subsection of Note 25 to the Corporation's consolidated financial statements, contained, respectively, at pages 23-25 and page 107 in the Corporation's 2005 Annual Report to shareholders furnished to shareholders in connection with the Annual Meeting of Shareholders on April 18, 2006, and incorporated herein by reference. Portions of the Annual Report not incorporated herein by reference are deemed not to be "filed" with the Commission with this report.
31(a)	Rule 13a-14(a) Certifications of CEO (pursuant to Section 302 of the Sarbanes-Oxley Act of 2002)

31(b) Rule 13a-14(a) Certifications of CFO (pursuant to Section 302 of the Sarbanes-Oxley Act of 2002)

32(a) 18 USC 1350 Certifications of CEO (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002)

32(b) 18 USC 1350 Certifications of CFO (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002)

\* The Corporation agrees to furnish copies of the instruments, including indentures, defining the rights of the holders of the long-term debt of the Corporation and its consolidated subsidiaries to the Securities and Exchange Commission upon request.

\*\* This is a management contract or compensatory plan required to be filed as an exhibit.

In many agreements filed as exhibits, each party makes representations and warranties to other parties. Those representations and warranties are made only to and for the benefit of those other parties in the context of a business contract. They are subject to contractual materiality standards. Exceptions to such representations and warranties may be partially or fully waived by such parties in their discretion. No such representation or warranty may be relied upon by any other person for any purpose.