

FIRST HORIZON NATIONAL CORP  
Form 10-Q  
August 07, 2007

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 June 30, 2007

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

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 x

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</u>	<u>126,236,535</u>
<u>value</u>	
Class	Outstanding on June 30, 2007

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FIRST HORIZON NATIONAL CORPORATION

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PART I.

FINANCIAL INFORMATION

Item 1. Financial Statements

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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.

**CONSOLIDATED CONDENSED  
STATEMENTS OF CONDITION****First Horizon National Corporation**

<i>(Dollars in thousands)(Unaudited)</i>	2007	June 30 2006	December 31 2006
<b>Assets:</b>			
Cash and due from banks	\$ 799,428	\$ 825,364	\$ 943,555
Federal funds sold and securities purchased under agreements to resell	1,121,052	1,572,143	1,202,537
Total cash and cash equivalents	1,920,480	2,397,507	2,146,092
Investment in bank time deposits	58,241	75,903	18,037
Trading securities	2,291,704	2,183,102	2,230,745
Loans held for sale	3,330,489	3,222,735	2,873,577
Securities available for sale	3,374,583	3,137,667	3,923,215
Securities held to maturity (fair value of \$271 on June 30, 2007; \$387 on June 30, 2006; and \$272 on December 31, 2006)	270	384	269
Loans, net of unearned income	22,382,303	21,717,264	22,104,905
Less: Allowance for loan losses	229,919	199,835	216,285
Total net loans	22,152,384	21,517,429	21,888,620
Mortgage servicing rights, net	1,522,966	1,595,413	1,533,942
Goodwill	279,825	281,910	275,582
Other intangible assets, net	61,947	75,055	64,530
Capital markets receivables	1,240,456	1,058,690	732,282
Premises and equipment, net	438,807	431,385	451,708
Real estate acquired by foreclosure	67,499	60,577	63,519
Discontinued assets	-	696	416
Other assets	1,654,433	1,430,781	1,715,725
<b>Total assets</b>	<b>\$ 38,394,084</b>	<b>\$ 37,469,234</b>	<b>\$ 37,918,259</b>
<b>Liabilities and shareholders' equity:</b>			
Deposits:			
Savings	\$ 3,520,757	\$ 3,246,821	\$ 3,354,180
Time deposits	2,885,307	2,819,597	2,924,050
Other interest-bearing deposits	1,822,076	1,894,707	1,969,700
Certificates of deposit \$100,000 and more	8,016,808	8,053,119	6,517,629
Interest-bearing	16,244,948	16,014,244	14,765,559
Noninterest-bearing	5,516,735	5,679,198	5,447,673
Total deposits	21,761,683	21,693,442	20,213,232

Federal funds purchased and securities sold under agreements to repurchase	3,841,251	3,387,711	4,961,799
Trading liabilities	658,533	929,694	789,957
Commercial paper and other short-term borrowings	246,815	721,227	1,258,513
Term borrowings	5,828,138	5,325,014	5,243,961
Other collateralized borrowings	821,966	281,280	592,399
Total long-term debt	6,650,104	5,606,294	5,836,360
Capital markets payables	1,144,029	1,057,617	799,489
Discontinued liabilities	-	8,422	6,966
Other liabilities	1,332,910	1,327,360	1,294,283
Total liabilities	35,635,325	34,731,767	35,160,599
Preferred stock of subsidiary	295,277	295,274	295,270
<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 - 126,236,535 on June 30, 2007; 123,947,391 on June 30, 2006; and 124,865,982 on December 31, 2006)	78,898	77,467	78,041
Capital surplus	352,138	282,563	312,521
Undivided profits	2,120,014	2,113,514	2,144,276
Accumulated other comprehensive loss, net	(87,568)	(31,351)	(72,448)
Total shareholders' equity	2,463,482	2,442,193	2,462,390
<b>Total liabilities and shareholders' equity</b>	<b>\$ 38,394,084</b>	<b>\$ 37,469,234</b>	<b>\$ 37,918,259</b>

See accompanying notes to consolidated condensed financial statements.

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

## CONSOLIDATED CONDENSED STATEMENTS OF INCOME

## First Horizon National Corporation

	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2007	2006	2007	2006
<i>(Dollars in thousands except per share data)(Unaudited)</i>				
<b>Interest income:</b>				
Interest and fees on loans	\$413,254	\$393,451	\$ 823,681	\$756,934
Interest on investment securities	47,105	41,747	101,375	77,886
Interest on loans held for sale	65,923	75,832	124,768	152,174

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Interest on trading securities	<b>50,069</b>	43,598	<b>90,632</b>	82,113
Interest on other earning assets	<b>18,552</b>	23,954	<b>37,632</b>	42,844
Total interest income	<b>594,903</b>	578,582	<b>1,178,088</b>	1,111,951
<b>Interest expense:</b>				
Interest on deposits:				
Savings	<b>29,919</b>	21,827	<b>55,950</b>	37,173
Time deposits	<b>33,555</b>	29,116	<b>66,592</b>	54,454
Other interest-bearing deposits	<b>6,808</b>	6,361	<b>13,697</b>	11,912
Certificates of deposit \$100,000 and more	<b>110,630</b>	110,068	<b>216,906</b>	229,364
Interest on trading liabilities	<b>14,272</b>	19,923	<b>30,633</b>	38,270
Interest on short-term borrowings	<b>68,932</b>	67,380	<b>136,096</b>	123,624
Interest on long-term debt	<b>91,355</b>	70,309	<b>181,363</b>	117,835
Total interest expense	<b>355,471</b>	324,984	<b>701,237</b>	612,632
<b>Net interest income</b>	<b>239,432</b>	253,598	<b>476,851</b>	499,319
Provision for loan losses	<b>44,408</b>	18,653	<b>72,894</b>	36,452
<b>Net interest income after provision for loan losses</b>	<b>195,024</b>	234,945	<b>403,957</b>	462,867
<b>Noninterest income:</b>				
Capital markets	<b>85,054</b>	102,165	<b>172,167</b>	195,023
Mortgage banking	<b>71,300</b>	116,472	<b>144,397</b>	197,154
Deposit transactions and cash management	<b>43,079</b>	42,756	<b>82,437</b>	80,779
Revenue from loan sales and securitizations	<b>9,615</b>	12,212	<b>19,278</b>	23,569
Insurance commissions	<b>7,674</b>	12,461	<b>17,463</b>	27,147
Trust services and investment management	<b>10,628</b>	10,824	<b>20,316</b>	21,481
Equity securities (losses)/gains, net	<b>(995)</b>	2,517	<b>2,967</b>	1,514
Debt securities (losses)/gains, net	<b>(19)</b>	376	<b>6,292</b>	(78,902)
All other income and commissions	<b>53,963</b>	35,229	<b>98,170</b>	64,857
Total noninterest income	<b>280,299</b>	335,012	<b>563,487</b>	532,622
<b>Adjusted gross income after provision for loan losses</b>	<b>475,323</b>	569,957	<b>967,444</b>	995,489
<b>Noninterest expense:</b>				
Employee compensation, incentives and benefits	<b>258,191</b>	245,796	<b>504,534</b>	505,937
Occupancy	<b>33,402</b>	27,525	<b>62,186</b>	57,627
Equipment rentals, depreciation and maintenance	<b>21,791</b>	17,858	<b>39,404</b>	38,122
Operations services	<b>17,457</b>	17,075	<b>35,278</b>	34,515
Communications and courier	<b>10,746</b>	13,409	<b>22,286</b>	28,321
Amortization of intangible assets	<b>2,623</b>	2,881	<b>5,448</b>	5,769
All other expense	<b>113,030</b>	98,467	<b>191,116</b>	187,801
Total noninterest expense	<b>457,240</b>	423,011	<b>860,252</b>	858,092
<b>Income before income taxes</b>	<b>18,083</b>	146,946	<b>107,192</b>	137,397
(Benefit)/provision for income taxes	<b>(3,861)</b>	43,013	<b>14,941</b>	30,054

<b>Income from continuing operations</b>	<b>21,944</b>	103,933	<b>92,251</b>	107,343
Income from discontinued operations, net of tax	<b>179</b>	376	<b>419</b>	210,649
<b>Income before cumulative effect of changes in accounting principle</b>	<b>22,123</b>	104,309	<b>92,670</b>	317,992
Cumulative effect of changes in accounting principle, net of tax	-	-	-	1,345
<b>Net income</b>	<b>\$ 22,123</b>	\$104,309	<b>\$ 92,670</b>	\$319,337
Earnings per common share from continuing operations	<b>\$ .18</b>	\$ .84	<b>\$ .74</b>	\$ .86
Earnings per common share from discontinued operations, net of tax	-	-	-	1.69
Earnings per common share from cumulative effect of changes in accounting principle	-	-	-	.01
<b>Earnings per common share (Note 7)</b>	<b>\$ .18</b>	\$ .84	<b>\$ .74</b>	\$ 2.56
Diluted earnings per common share from continuing operations	<b>\$ .17</b>	\$ .82	<b>\$ .72</b>	\$ .84
Diluted earnings per common share from discontinued operations, net of tax	-	-	-	1.64
Diluted earnings per common share from cumulative effect of changes in accounting principle	-	-	-	.01
<b>Diluted earnings per common share (Note 7)</b>	<b>\$ .17</b>	\$ .82	<b>\$ .72</b>	\$ 2.49
<b>Weighted average common shares (Note 7)</b>	<b>125,873</b>	123,667	<b>125,609</b>	124,573
<b>Diluted average common shares (Note 7)</b>	<b>128,737</b>	127,280	<b>128,720</b>	128,185
See accompanying notes to consolidated condensed financial statements.				
Certain previously reported amounts have been reclassified to agree with current presentation.				

**CONSOLIDATED CONDENSED STATEMENTS OF SHAREHOLDERS' EQUITY**
*(Dollars in thousands)(Unaudited)*

	<b>First Horizon National Corporation</b>	
	<b>2007</b>	2006
Balance, January 1	<b>\$2,462,390</b>	\$2,347,539
Adjustment to reflect change in accounting for tax benefits (FIN 48)	<b>(862)</b>	-
Adjustment to reflect adoption of measurement date provisions for SFAS No. 158	<b>6,233</b>	-
Adjustment to reflect change in accounting for purchases of life insurance (EITF Issue No. 06-5)	<b>(548)</b>	-
Net income	<b>92,670</b>	319,337
Other comprehensive income:		

Unrealized fair value adjustments, net of tax:		
Cash flow hedges	(29)	966
Securities available for sale	(25,963)	9,927
Comprehensive income	66,678	330,230
Cash dividends declared	(113,450)	(111,752)
Common stock repurchased	(1,096)	(165,568)
Common stock issued for:		
Stock options and restricted stock	30,506	34,878
Acquisitions	-	487
Excess tax benefit from stock-based compensation arrangements	6,029	3,592
Adjustment to reflect change in accounting for employee stock option forfeitures	-	(1,780)
Recognized pension and other employee benefit plans net periodic benefit costs	2,562	-
Stock-based compensation expense	5,009	4,567
Other	31	-
<b>Balance, June 30</b>	<b>\$2,463,482</b>	<b>\$2,442,193</b>

See accompanying notes to consolidated condensed financial statements.

## CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Dollars in thousands)(Unaudited)

	First Horizon C Six Months En 30 2007
<b>Operating</b> Net income	<b>\$ 92,670</b>
<b>Activities</b> Adjustments to reconcile net income to net cash provided/(used) by operating activities:	
Provision for loan losses	72,894
Provision for deferred income tax	14,941
Depreciation and amortization of premises and equipment	27,231
Amortization of intangible assets	5,448
Net other amortization and accretion	42,386
Decrease in derivatives, net	58,724
Market value adjustment on mortgage servicing rights	(100,230)
Provision for foreclosure reserve	6,101
Cumulative effect of changes in accounting principle, net of tax	-
Gain on divestiture	-
Stock-based compensation expense	5,009
Excess tax benefit from stock-based compensation arrangements	(6,029)
Equity securities gains, net	(2,967)
Debt securities (gains)/losses, net	(6,292)
Net losses on disposal of fixed assets	588
Net (increase)/decrease in:	
Trading securities	(60,959)
Loans held for sale	(456,912)
Capital markets receivables	(508,174)
Interest receivable	11,013

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	Other assets	119,737
	Net increase/(decrease) in:	
	Capital markets payables	344,540
	Interest payable	5,600
	Other liabilities	(48,599)
	Trading liabilities	(131,424)
	Total adjustments	(607,374)
	Net cash (used)/provided by operating activities	(514,704)
<b>Investing</b>	Available for sale securities:	
<b>Activities</b>	Sales	624,240
	Maturities	368,577
	Purchases	(469,738)
	Premises and equipment:	
	Sales	-
	Purchases	(15,322)
	Net increase in loans	(367,402)
	Net increase in investment in bank time deposits	(40,200)
	Proceeds from divestitures, net of cash and cash equivalents	-
	Acquisitions, net of cash and cash equivalents acquired	-
	Net cash provided/(used) by investing activities	100,155
<b>Financing</b>	Common stock:	
<b>Activities</b>	Exercise of stock options	30,571
	Cash dividends paid	(112,085)
	Repurchase of shares	(1,096)
	Excess tax benefit from stock-based compensation arrangements	6,029
	Long-term debt:	
	Issuance	1,076,909
	Payments	(227,604)
	Issuance of preferred stock of subsidiary	8
	Repurchase of preferred stock of subsidiary	(1)
	Net increase/(decrease) in:	
	Deposits	1,548,452
	Short-term borrowings	(2,132,246)
	Net cash provided/(used) by financing activities	188,937
	Net decrease in cash and cash equivalents	(225,612)
	Cash and cash equivalents at beginning of period	2,146,092
	Cash and cash equivalents at end of period	\$1,920,480
	Cash and cash equivalents from discontinued operations at beginning of period, included above	\$ -
	Total interest paid	694,751
	Total income taxes paid	13,782

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 2007 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 2006 Annual Report to shareholders.

**Income Taxes.** FHN or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction and various state's jurisdiction. With few exceptions, FHN is no longer subject to U.S. federal or state and local income tax examinations by tax authorities for years before 2002. The Internal Revenue Service (IRS) has completed its examination of all U.S. federal returns through 2004, although 2003 and 2004 remain open under the statute. All proposed adjustments with respect to examinations of federal returns filed for 2004 and prior years have been settled.

FHN adopted the provisions of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48), on January 1, 2007. As a result of the implementation of FIN 48, FHN recognized a \$.9 million increase in the liability for unrecognized tax benefits, which was accounted for as a reduction to the January 1, 2007, balance of undivided profits. The total balance of unrecognized tax benefits at January 1, 2007, was \$41.0 million. First Horizon does not expect that unrecognized tax benefits will significantly increase or decrease within the next 12 months. Included in the balance at January 1, 2007, were \$15.6 million of tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Because of the impact of deferred tax accounting, other than interest, the disallowance of the shorter deductibility period would not affect the annual effective tax rate but would accelerate the payment of cash to the taxing authority to an earlier period. FHN recognizes interest accrued related to unrecognized tax benefits in tax expense and penalties in tax expense. FHN had approximately \$4.8 million for the payment of interest accrued at January 1, 2007. As of June 30, 2007, no significant changes to these amounts have occurred since the adoption of FIN 48.

**Accounting Changes.** Effective January 1, 2007, FHN adopted 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 require an assessment in accordance with SFAS No. 133 to determine if an embedded derivative exists within the instrument. In addition, effective January 1, 2007, FHN adopted Derivatives Implementation Group Issue B40, "Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets" (DIG B40). DIG B40 provides an exemption from the embedded derivative test of paragraph 13(b) of SFAS No. 133 for instruments that would otherwise require bifurcation if the test is met solely because of a prepayment feature included within the securitized interest and prepayment is not controlled by the security holder.

Since FHN presents all retained interests in its proprietary securitizations as trading securities and due to the clarifying guidance of DIG B40, the impact of adopting SFAS No. 155 was immaterial to the results of operations.

Effective January 1, 2007, FHN adopted FIN 48 which 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. As previously mentioned, upon adoption of FIN 48, FHN recognized a cumulative effect adjustment to the beginning balance of undivided profits in the amount of \$.9 million for differences between the tax benefits recognized in the statements of condition prior to the adoption of FIN 48 and the amounts reported after adoption.

Effective January 1, 2007, FHN adopted 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). EITF 06-5 provides that in addition to cash surrender value, the asset recognized for a life insurance contract should consider certain other provisions included in a policy's contractual terms with additional amounts being discounted if receivable beyond one year. 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. FHN recognized a reduction of undivided profits in the amount of \$.5 million as a result of adopting EITF 06-5.

Effective January 1, 2007, FHN elected early adoption of the final provisions of 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 required that the annual measurement date of a plan's assets and liabilities be as

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

of the date of the financial statements. As a result of adopting the measurement date provisions of SFAS No. 158, total equity was increased by \$6.2 million on January 1, 2007, consisting of a reduction to undivided profits of \$2.1 million and a credit to accumulated other comprehensive income of \$8.3 million. Effective December 31, 2006, FHN adopted the provisions of SFAS No. 158 related to the requirements to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in the statements of condition. SFAS No. 158 did 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. As a result of adopting the recognition provisions of SFAS No. 158, unrecognized transition assets and obligations, unrecognized actuarial gains and losses, and unrecognized prior service costs and credits were recognized as a component of accumulated other comprehensive income resulting in a reduction in equity of \$76.7 million, net of tax, on December 31, 2006.

In fiscal 2006, FHN adopted SEC Staff Accounting Bulletin No. 108 (SAB No. 108). SAB No. 108 requires that registrants assess the impact on both the statement of condition and the statement of income 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 to a reporting period presented within the financial statements, after considering all relevant quantitative and qualitative factors. The adoption of SAB No. 108 had no effect on FHN's statement of condition or results of operations.

Effective January 1, 2006, FHN elected early adoption of SFAS No. 156, "Accounting for Servicing of Financial Assets – an amendment of FASB Statement No. 140". 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, "Share-Based Payment", 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 is 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.

***Accounting Changes Issued but Not Currently Effective.*** In June 2007, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position 07-1, "Clarification of the Scope of the Audit and Accounting Guide *Investment Companies* and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies" (SOP 07-1), which provides guidance for determining whether an entity is within the scope of the AICPA's Investment Companies Guide. Additionally, SOP 07-1 provides certain criteria that must be met in order for investment company accounting applied by a subsidiary or equity method investee to be retained in the financial statements of the parent company or an equity method investor. SOP 07-1 also provides expanded disclosure requirements regarding the retention of such investment company accounting in the consolidated financial statements. In May 2007, FASB Staff Position No. FIN 46(R)-7, "Application of FASB Interpretation No. 46(R) to Investment Companies" (FIN 46(R)-7) was issued. FIN 46(R)-7 amends FIN 46(R) to provide a permanent exception to its scope for companies within the scope of the revised Investment Companies Guide under SOP 07-1. SOP 07-1 and FIN 46(R)-7

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

are effective for fiscal years beginning on or after December 15, 2007. FHN is currently assessing the financial impact of adopting SOP 07-1 and FIN 46(R)-7.

In April 2007, FASB Staff Position No. FIN 39-1, "Amendment of FASB Interpretation No. 39" (FIN 39-1) was issued. FIN 39-1 permits the offsetting of fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral against fair value amounts recognized for derivative instruments executed with the

same counterparty under the same master netting arrangement. Upon adoption of FIN 39-1, entities are permitted to change their previous accounting policy election to offset or not offset fair value amounts recognized for derivative instruments under master netting arrangements. Additionally, FIN 39-1 requires additional disclosures for derivatives and collateral associated with master netting arrangements. FIN 39-1 is effective for fiscal years beginning after November 15, 2007, through retrospective application, with early application permitted. FHN is currently assessing the financial impact of adopting FIN 39-1.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS No. 159), which allows an irrevocable election to measure certain financial assets and financial liabilities at fair value on an instrument-by-instrument basis, with unrealized gains and losses recognized currently in earnings. Under SFAS No. 159, the fair value option may only be elected at the time of initial recognition of a financial asset or financial liability or upon the occurrence of certain specified events. Additionally, SFAS No. 159 provides that application of the fair value option must be based on the fair value of an entire financial asset or financial liability and not selected risks inherent in those assets or liabilities. SFAS No. 159 requires that assets and liabilities which are measured at fair value pursuant to the fair value option be reported in the financial statements in a manner that separates those fair values from the carrying amounts of similar assets and liabilities which are measured using another measurement attribute. SFAS No. 159 also provides expanded disclosure requirements regarding the effects of electing the fair value option on the financial statements. SFAS No. 159 is effective prospectively for fiscal years beginning after November 15, 2007. FHN is currently assessing the financial impact of adopting SFAS No. 159.

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 regarding the effects of fair value measurements on the financial statements. SFAS No. 157 is effective prospectively for fiscal years beginning after November 15, 2007. FHN is currently assessing the financial impact of adopting SFAS No. 157.

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 because such obligations are not considered to be 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 undivided profits. FHN is currently assessing the financial impact of adopting EITF 06-4.

## **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 \$351.5 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.

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

### Note 3 - Loans

The composition of the loan portfolio is detailed below:

<i>(Dollars in thousands)</i>	June 30		December 31
	<b>2007</b>	2006	2006
Commercial:			
Commercial, financial and industrial	<b>\$ 7,218,582</b>	\$ 6,705,925	\$ 7,201,009
Real estate commercial	<b>1,389,963</b>	1,276,278	1,136,590
Real estate construction	<b>2,830,856</b>	2,453,579	2,753,458
Retail:			
Real estate residential	<b>7,614,887</b>	8,562,733	7,973,313
Real estate construction	<b>2,158,775</b>	2,076,004	2,085,133
Other retail	<b>149,157</b>	163,121	161,178
Credit card receivables	<b>194,715</b>	202,117	203,307
Real estate loans pledged against other collateralized borrowings	<b>825,368</b>	277,507	590,917
Loans, net of unearned income	<b>22,382,303</b>	21,717,264	22,104,905
Allowance for loan losses	<b>229,919</b>	199,835	216,285
Total net loans	<b>\$22,152,384</b>	\$21,517,429	\$21,888,620

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

Nonperforming loans consist of loans which management has identified as impaired, other nonaccrual loans and loans which have been restructured. On June 30, 2007 and 2006, there were no outstanding commitments to advance additional funds to customers whose loans had been restructured. The following table presents nonperforming loans on:

<i>(Dollars in thousands)</i>	June 30		December 31
	<b>2007</b>	2006	2006
Impaired loans	<b>\$ 119,043</b>	\$ 56,394	\$ 76,340
Other nonaccrual loans*	<b>21,466</b>	19,940	17,290
Total nonperforming loans	<b>\$ 140,509</b>	\$ 76,334	\$ 93,630

\* On June 30, 2007 and 2006, and on December 31, 2006, other nonaccrual loans included \$12.5 million,

\$15.0 million,  
and  
\$10.8  
million,  
respectively, of  
loans held for  
sale.

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:

	Three Months Ended		Six Months Ended	
	June 30		June 30	
<i>(Dollars in thousands)</i>	2007	2006	2007	2006
Total interest on impaired loans	\$ 154	\$ 165	\$ 495	\$ 344
Average balance of impaired loans	95,777	48,689	89,722	46,261

Activity in the allowance for loan losses related to non-impaired loans, impaired loans, and for the total allowance for the six months ended June 30, 2007 and 2006, is summarized as follows:

<i>(Dollars in thousands)</i>	Non-impaired	Impaired	Total
Balance on December 31, 2005	\$179,635	\$10,070	\$189,705
Provision for loan losses	25,589	10,863	36,452
Divestitures/acquisitions/transfers	(1,195)	-	(1,195)
Charge-offs	(23,034)	(9,275)	(32,309)
Recoveries	5,533	1,649	7,182
Net charge-offs	(17,501)	(7,626)	(25,127)
Balance on June 30, 2006	\$186,528	\$13,307	\$199,835
Balance on December 31, 2006	\$200,827	\$15,458	\$216,285
Provision for loan losses	32,921	39,973	72,894
Divestitures/acquisitions/transfers	(10,961)	1,290	(9,671)
Charge-offs	(23,181)	(32,977)	(56,158)
Recoveries	4,489	2,080	6,569
Net charge-offs	(18,692)	(30,897)	(49,589)
<b>Balance on June 30, 2007</b>	<b>\$204,095</b>	<b>\$25,824</b>	<b>\$229,919</b>

#### 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 \$106.3 billion of mortgage loans on June 30, 2007, for which a servicing right has been capitalized.

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.

Following is a summary of changes in capitalized MSR as of June 30, 2007 and 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	212,821	10,627	3,862
Reductions due to loan payments	(130,911)	(1,752)	(4,338)
Changes in fair value due to:			
Changes in current market interest rates	165,182	95	1,029
Other changes in fair value	338	17	370
Fair value on June 30, 2006	\$1,565,649	\$14,457	\$15,307
Fair value on January 1, 2007	\$1,495,215	\$24,091	\$14,636
Addition of mortgage servicing rights	185,257	7,995	1,832
Reductions due to loan payments	(124,359)	(4,547)	(2,837)
Changes in fair value due to:			
Changes in current market interest rates	100,215	66	-
Reclassification to trading assets	(174,547)	-	-
Other changes in fair value	(54)	3	-
<b>Fair value on June 30, 2007</b>	<b>\$1,481,727</b>	<b>\$27,608</b>	<b>\$13,631</b>

In conjunction with capital management initiatives, FHN modified Pooling and Servicing Agreements (PSA) on its private securitizations during the second quarter of 2007 to segregate the retained yield component from the master servicing fee. The retained yield of \$174.5 million was reclassified from mortgage servicing rights to trading securities on the Consolidated Condensed Statements of Condition.

## Note 5 - Intangible Assets

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

<i>(Dollars in thousands)</i>	Goodwill	Other Intangible Assets*
December 31, 2005	\$281,440	\$ 76,647
Amortization expense	-	(5,769)

Additions	1,580	4,300
Divestitures	(1,110)	(123)
June 30, 2006	\$281,910	\$ 75,055
December 31, 2006	\$275,582	\$ 64,530
Amortization expense	-	(5,448)
Divestitures	-	(60)
Additions**	4,243	2,925
<b>June 30, 2007</b>	<b>\$279,825</b>	<b>\$ 61,947</b>

\* 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 \$138.3 million on June 30, 2007, net of \$76.4 million of accumulated amortization. Estimated aggregate amortization expense for the remainder of 2007 is expected to be \$5.3 million and is expected to be \$8.9 million, \$6.9 million, \$6.0 million and \$5.7 million for the twelve-month periods of 2008, 2009, 2010 and 2011, respectively.

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

<i>(Dollars in thousands)</i>	Retail/ Commercial	Mortgage	Capital	Total
	Banking	Banking	Markets	
December 31, 2005	\$104,781	\$61,593	\$115,066	\$281,440
Divestitures	(1,110)	-	-	(1,110)
Additions	30	1,550	-	1,580
June 30, 2006	\$103,701	\$63,143	\$115,066	\$281,910
December 31, 2006	\$ 94,276	\$66,240	\$115,066	\$275,582
Additions*	-	4,243	-	4,243
<b>June 30, 2007</b>	<b>\$ 94,276</b>	<b>\$70,483</b>	<b>\$115,066</b>	<b>\$279,825</b>

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

## Note 6 - 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



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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 June 30, 2007, 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 11.73 percent, 8.11 percent and 6.65 percent, respectively, on June 30, 2007, and were 12.07 percent, 8.25 percent and 6.71 percent, respectively, on June 30, 2006.

<i>(Dollars in thousands)</i>	First Horizon National Corporation		First Tennessee Bank National Association	
	Amount	Ratio	Amount	Ratio
<b>On June 30, 2007:</b>				
Actual:				
Total Capital	\$4,027,528	12.90%	\$3,797,809	12.31%
Tier 1 Capital	2,711,329	8.68	2,581,611	8.37
Leverage	2,711,329	7.00	2,581,611	6.72
For Capital Adequacy Purposes:				
Total Capital	2,497,928	≥ 8.00	2,468,136	≥ 8.00
Tier 1 Capital	1,248,964	≥ 4.00	1,234,068	≥ 4.00
Leverage	1,549,325	≥ 4.00	1,537,335	≥ 4.00
To Be Well Capitalized Under Prompt Corrective Action Provisions:				
Total Capital			3,085,170	≥ 10.00
Tier 1 Capital			1,851,102	≥ 6.00
Leverage			1,921,669	≥ 5.00
<b>On June 30, 2006:</b>				
Actual:				
Total Capital	\$3,943,421	13.13%	\$3,757,888	12.61%
Tier 1 Capital	2,612,228	8.70	2,526,694	8.48
Leverage	2,612,228	6.86	2,526,694	6.69
For Capital Adequacy Purposes:				
Total Capital	2,402,466	≥ 8.00	2,383,795	≥ 8.00
Tier 1 Capital	1,201,233	≥ 4.00	1,191,897	≥ 4.00
Leverage	1,523,082	≥ 4.00	1,511,220	≥ 4.00
To Be Well Capitalized Under Prompt Corrective Action Provisions:				
Total Capital			2,979,744	≥ 10.00
Tier 1 Capital			1,787,846	≥ 6.00
Leverage			1,889,025	≥ 5.00

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

**Note 7 - Earnings Per Share**

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

<i>(In thousands, except per share data)</i>	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2007	2006	2007	2006
Net income from continuing operations	\$ 21,944	\$ 103,933	\$ 92,251	\$ 107,343
Income from discontinued operations, net of tax	179	376	419	210,649
Cumulative effect of changes in accounting principle, net of tax	-	-	-	1,345
Net income	\$ 22,123	\$ 104,309	\$ 92,670	\$ 319,337
Weighted average common shares	125,873	123,667	125,609	124,573
Effect of dilutive securities	2,864	3,613	3,111	3,612
Diluted average common shares	128,737	127,280	128,720	128,185

**Earnings per common share:**

Net income from continuing operations	\$ .18	\$ .84	\$ .74	\$ .86
Income from discontinued operations, net of tax	-	-	-	1.69
Cumulative effect of changes in accounting principle, net of tax	-	-	-	.01
Net income	\$ .18	\$ .84	\$ .74	\$ 2.56

**Diluted earnings per common share:**

Net income from continuing operations	\$ .17	\$ .82	\$ .72	\$ .84
Income from discontinued operations, net of tax	-	-	-	1.64
Cumulative effect of changes in accounting principle, net of tax	-	-	-	.01
Net income	\$ .17	\$ .82	\$ .72	\$ 2.49

Equity awards of 7,850 and 6,124 with weighted average exercise prices of \$41.81 and \$42.62 per share for the three months ended June 30, 2007 and 2006, respectively, and of 5,843 and 5,891 with weighted average exercise prices of \$42.46 and \$42.69 per share for the six months ended June 30, 2007 and 2006, 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.

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.

**Note 8 - 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 concerned 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 sought 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 certified a statewide class action involving approximately 4,000 loans and made a number of rulings that could have significantly affected the ultimate outcome of the case in the absence of an appeal. Trial had been scheduled for the fourth quarter of 2006.

As a result of mediation, FHN entered into a final settlement agreement related to the McGuire lawsuit. In connection with this settlement, FHN agreed to pay, under agreed circumstances using an agreed methodology, an aggregate of up to approximately \$36 million. At the present time, the period during which claims under the settlement can be made has ended, and the claims that have been received are being evaluated. The total amount currently reserved for this matter, based on the claims received and FHN's evaluation of them to date, is approximately \$30 million. The settlement has received final approval by the court, the court has entered its order making the settlement final, there have been no appeals, and the time for any appeals has expired.

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 amount and value of claims received. The ultimate amount paid under the settlement is not expected to be higher than the amount reserved at present, and may be lower in the event some of the claims are reduced or rejected for reasons set forth in the settlement, and in any event 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 \$106.0 billion on June 30, 2007, 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 losses on the mortgage servicing portfolio of approximately \$14.6 million and \$15.1 million on June 30, 2007 and 2006, 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 June 30, 2007 and 2006, First Horizon Home Loans had single-family residential loans with outstanding balances of \$110.5 million and \$146.2 million, respectively, that were serviced on a full recourse basis. On June 30, 2007 and 2006, 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 \$3.2 billion and \$2.9 billion,

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**Note 8 - Contingencies and Other Disclosures (continued)**

respectively. Additionally, on June 30, 2007 and 2006, \$4.8 billion and \$5.3 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 June 30, 2007, the outstanding principal balance of these loans was \$303.1 million and \$82.5 million, respectively. On June 30, 2006, the outstanding principal balance of securitized and sold HELOC and second-lien mortgages was \$482.5 million and \$116.0 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 \$33.7 million and \$56.7 million on June 30, 2007 and 2006, 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 9 – 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 \$225,000 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.

Effective December 31, 2006, FHN adopted SFAS No. 158, which required the recognition of the overfunded or underfunded status of a defined benefit plan and postretirement plan as an asset or liability in the statements of condition. SFAS No. 158 did not change measurement or recognition requirements for periodic pension and postretirement costs. Effective January 1, 2007, FHN adopted the final provisions of SFAS No. 158, which required that the annual measurement date of a plan's assets and liabilities be as of the date of the financial statements. As a result of adopting the measurement provisions of SFAS No. 158, undivided profits were reduced by \$2.1 million, net of tax, and accumulated other comprehensive income was credited by \$8.3 million, net of tax.

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

<i>(Dollars in thousands)</i>	Pension Benefits		Postretirement Benefits	
	2007	2006	2007	2006
<b>Components of net periodic benefit cost/(benefit)</b>				
Service cost	\$ 4,327	\$ 4,520	\$ 75	\$ 83
Interest cost	6,154	5,486	278	279
Expected return on plan assets	(10,637)	(8,945)	(441)	(421)
Amortization of prior service cost/(benefit)	220	211	(44)	(44)
Recognized losses/(gains)	1,810	1,769	(178)	(140)
Amortization of transition obligation	-	-	247	247
Net periodic cost/(benefit)	\$ 1,874	\$ 3,041	\$ (63)	\$ 4

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

<i>(Dollars in thousands)</i>	Pension Benefits		Postretirement Benefits	
	2007	2006	2007	2006
<b>Components of net periodic benefit cost/(benefit)</b>				
Service cost	\$ 8,654	\$ 9,040	\$ 150	\$ 166
Interest cost	12,308	10,971	556	558
Expected return on plan assets	(21,274)	(17,889)	(882)	(841)
Amortization of prior service cost/(benefit)	440	422	(88)	(88)
Recognized losses/(gains)	3,620	3,537	(356)	(281)
Amortization of transition obligation	-	-	494	494
Net periodic cost/(benefit)	\$ 3,748	\$ 6,081	\$ (126)	\$ 8

#### Note 9 – Pension and Other Employee Benefits (continued)

FHN made a contribution of \$37 million to the pension plan in fourth quarter 2006 and made an additional contribution of \$37 million in first quarter 2007. Both of these contributions were attributable to the 2006 plan year. FHN expects to make no additional contributions to the pension plan or to the other employee benefit plan in 2007.

**Note 10 – 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, which was accounted for as a discontinued operation, 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, revenue and expense associated with deferred compensation plans, funds management, and venture capital. Periodically, FHN adapts its segments to reflect changes in expense allocations between segments. Previously reported amounts have been reclassified to agree with current presentation.

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 six months ended June 30:

	Three Months Ended		Six Months Ended	
	June 30		June 30	
<i>(Dollars in thousands)</i>	2007	2006	2007	2006
<b>Total Consolidated</b>				
Net interest income	\$ 239,432	\$ 253,598	\$ 476,851	\$ 499,319
Provision for loan losses	44,408	18,653	72,894	36,452
Noninterest income	280,299	335,012	563,487	532,622
Noninterest expense	457,240	423,011	860,252	858,092
Pre-tax income	18,083	146,946	107,192	137,397
(Benefit)/provision for income taxes	(3,861)	43,013	14,941	30,054
Income from continuing operations	21,944	103,933	92,251	107,343
Income from discontinued operations, net of tax	179	376	419	210,649
Income before cumulative effect of changes in accounting principle	22,123	104,309	92,670	317,992
Cumulative effect of changes in accounting principle, net of tax	-	-	-	1,345
Net income	\$ 22,123	\$ 104,309	\$ 92,670	\$ 319,337

Average assets **\$ 39,070,144** \$ 38,494,898 **\$ 38,859,763** \$ 38,094,435  
 Certain previously reported amounts have been reclassified to agree with current presentation.

**Note 10 – Business Segment Information (continued)**

<i>(Dollars in thousands)</i>	Three Months Ended		Six Months Ended	
	2007	2006	2007	2006
<b>Retail/Commercial Banking</b>				
Net interest income	\$ 217,896	\$ 232,496	\$ 442,012	\$ 458,236
Provision for loan losses	36,847	18,361	65,340	36,387
Noninterest income	106,649	113,984	209,608	221,723
Noninterest expense	206,217	214,744	404,412	433,110
Pre-tax income	81,481	113,375	181,868	210,462
Provision for income taxes	22,774	29,581	53,032	57,210
Income from continuing operations	58,707	83,794	128,836	153,252
Income from discontinued operations, net of tax	179	376	419	210,649
Income before cumulative effect	58,886	84,170	129,255	363,901
Cumulative effect of changes in accounting principle, net of tax	-	-	-	522
Net income	\$ 58,886	\$ 84,170	\$ 129,255	\$ 364,423
Average assets	\$ 23,837,809	\$ 23,021,401	\$ 23,693,540	\$ 22,992,194
<b>Mortgage Banking</b>				
Net interest income	\$ 24,353	\$ 25,494	\$ 41,696	\$ 51,332
Provision for loan losses	(111)	292	(118)	65
Noninterest income	74,967	119,608	151,701	203,335
Noninterest expense	115,565	115,155	220,896	229,911
Pre-tax (loss)/income	(16,134)	29,655	(27,381)	24,691
(Benefit)/provision for income taxes	(8,493)	10,392	(20,275)	8,598
Loss before cumulative effect	(7,641)	19,263	(7,106)	16,093
Cumulative effect of changes in accounting principle, net of tax	-	-	-	414
Net (loss)/income	\$ (7,641)	\$ 19,263	\$ (7,106)	\$ 16,507
Average assets	\$ 6,818,527	\$ 6,617,849	\$ 6,536,236	\$ 6,414,714
<b>Capital Markets</b>				
Net interest expense	\$ (3,865)	\$ (4,642)	\$ (9,702)	\$ (10,336)

Noninterest income	<b>90,417</b>	104,125	<b>179,346</b>	200,731
Noninterest expense	<b>73,846</b>	83,629	<b>153,572</b>	166,230
Pre-tax income	<b>12,706</b>	15,854	<b>16,072</b>	24,165
Provision for income taxes	<b>4,741</b>	5,924	<b>5,958</b>	8,999
Income before cumulative effect	<b>7,965</b>	9,930	<b>10,114</b>	15,166
Cumulative effect of changes in accounting principle, net of tax	-	-	-	179
Net income	<b>\$ 7,965</b>	\$ 9,930	<b>\$ 10,114</b>	\$ 15,345
Average assets	<b>\$ 4,382,041</b>	\$ 5,079,308	<b>\$ 4,407,086</b>	\$ 4,928,022

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

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**Note 10 – Business Segment Information (continued)**

<i>(Dollars in thousands)</i>	Three Months Ended June 30		Six Months Ended June 30	
	<b>2007</b>	2006	<b>2007</b>	2006
<b>Corporate</b>				
Net interest income	<b>\$ 1,048</b>	\$ 250	<b>\$ 2,845</b>	\$ 87
Provision for loan losses	<b>7,672</b>	-	<b>7,672</b>	-
Noninterest income/(expense)	<b>8,266</b>	(2,705)	<b>22,832</b>	(93,167)
Noninterest expense	<b>61,612</b>	9,483	<b>81,372</b>	28,841
Pre-tax loss	<b>\$ (59,970)</b>	\$ (11,938)	<b>\$ (63,367)</b>	\$ (121,921)
Benefit for income taxes	<b>(22,883)</b>	(2,884)	<b>(23,774)</b>	(44,753)
Loss before cumulative effect	<b>(37,087)</b>	(9,054)	<b>(39,593)</b>	(77,168)
Cumulative effect of changes in accounting principle, net of tax	-	-	-	230
Net loss	<b>\$ (37,087)</b>	\$ (9,054)	<b>\$ (39,593)</b>	\$ (76,938)
Average assets	<b>\$ 4,031,767</b>	\$ 3,776,340	<b>\$ 4,222,901</b>	\$ 3,759,505

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

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**Note 11 – 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 freestanding 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, exclusive of the value of associated servicing rights, 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 11 – 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 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 \$2.6 billion and \$1.8 billion on June 30, 2007 and 2006, respectively. The balance sheet impacts of the related derivatives were net assets of \$20.0 million and \$7.8 million on June 30, 2007 and 2006, respectively. Net losses of \$1.6 million and \$10.4 million representing the ineffective portion of these fair value hedges were recognized as a component of gain or loss on sale of loans for the six months ended June 30, 2007 and 2006, respectively.

In 2006, due to adoption of SFAS No. 156, First Horizon began revaluing 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 also enters into economic 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.

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.

### **Note 11 – Derivatives (continued)**

In 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 first quarter 2006, \$.1 million 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 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 \$61.9 million and \$60.8 million on June 30, 2007 and 2006, respectively. These swaps have been accounted for as fair value hedges under the shortcut method. The balance sheet impact of these swaps was \$.6 million and \$1.7 million in other liabilities on June 30, 2007 and 2006, 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 on June 30, 2007 and 2006. These swaps have been accounted for as fair value hedges under the shortcut method. The balance sheet impact of these swaps was \$41.5 million and \$56.0 million

in other liabilities on June 30, 2007 and 2006, 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.

In first quarter 2006, FHN 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 totaling \$.3 billion on June 30, 2007 and 2006. The balance sheet impact of these swaps was \$29.7 million and \$33.1 million in other liabilities on June 30, 2007 and 2006, respectively. There was no ineffectiveness related to these hedges. 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 utilized an interest rate swap as a cash flow hedge of the interest payment on floating-rate bank notes with fair values of \$100.5 million and \$101.4 million on June 30, 2007 and 2006, respectively, and a maturity in first quarter 2009. The balance sheet impact of this swap was \$.5 million in other assets and \$.3 million, net of tax, in other comprehensive income on June 30, 2007, and was \$1.4 million in other assets and \$.9 million, net of tax, in other comprehensive income on June 30, 2006. There was no ineffectiveness related to this hedge.

## **Note 12 - Restructuring, Repositioning, and Efficiency Charges**

In March 2007, FHN began Phases 2 and 3 of an ongoing, company-wide review of business practices with the goal of improving FHN's overall profitability and productivity. As a result of actions taken in the second quarter of 2007, FHN recorded pretax expenses of \$39.3 million. Of this amount, \$14.8 million represents exit costs that have been accounted for in accordance with Statement of Financial Accounting Standards No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" (SFAS No. 146).

Expenses resulted from the following actions:

- Expense of \$8.0 million associated with organizational and compensation changes for right sizing operating segments and consolidating functional areas.
- Non-core business repositioning costs of \$17.0 million, including costs associated with the exit of the collectible coin merchandising business and the transition of the non-prime mortgage origination business to a broker model.
- Expense of \$14.3 million related to other restructuring, repositioning, and efficiency initiatives, including facilities consolidation, procurement centralization, multi-sourcing and the divestiture of certain loan portfolios.

Expenses incurred in relation to the divestiture of a non-strategic loan portfolio are included in the provision for loan losses. All other costs associated with the restructuring, repositioning, and efficiency initiatives implemented by management are included in the noninterest expense section of the income statement, including severance and other employee-related costs recognized in relation to such initiatives which are recorded in employee compensation, incentives, and benefits, facilities consolidation costs which are included in occupancy, costs associated with the

impairment of premises and equipment which are included in equipment rentals, depreciation, and maintenance, and other costs associated with such initiatives, including professional fees, as well as asset impairment and repositioning costs associated with the exit from the collectible coin merchandising business, which are included in all other expense. Additional estimated pretax charges of up to \$60 million are anticipated to be recognized in relation to the continuing implementation of the currently identified restructuring, repositioning, and efficiency initiatives, through the targeted completion date for Phases 2 and 3 at the end of 2007. Further, subsequent to the end of the second quarter of 2007, management decided to pursue the sale, closure, or consolidation of 34 full-service First Horizon Bank branches in Atlanta, Baltimore, Dallas and Northern Virginia, while maintaining a national specialty banking focus in those areas. Charges in addition to those currently identified are anticipated from the sale, closure, or consolidation of such branches. At this time, the amounts and exact timing of additional charges cannot be reasonably estimated.

Activity in the restructuring and repositioning liability for the three months ended June 30, 2007 is presented in the following table, along with other restructuring and repositioning expenses recognized. All costs associated with the restructuring, repositioning, and efficiency initiatives implemented in the second quarter of 2007 are recorded as unallocated corporate charges within the Corporate segment.

<i>(Dollars in thousands)</i>	Three Months Ended June 30, 2007	
	Charged to Expense	Liability
Beginning Balance	\$ -	\$ -
Severance and other employee related costs*	7,997	7,997
Facility consolidation costs	3,788	3,788
Other exit costs, professional fees and other	2,969	2,969
Total Accrued	14,754	14,754
Payments**	-	3,905
Accrual Reversals	-	-
Restructuring & Repositioning Reserve Balance	\$14,754	\$10,849
Other Restructuring & Repositioning Expenses:		
Loan Portfolio Divestiture	7,672	
Impairment of Premises and Equipment	5,159	
Impairment of Other Assets	11,733	
Total Other Restructuring & Repositioning Expenses	24,564	
Total Charged to Expense	\$39,318	

\* Includes \$1.2 million of deferred severance-related payments that will be paid after 2008.

\*\* Includes payments of \$2.3 million related to severance and other employee related costs, payment of \$.1 million for facility consolidation costs, and \$1.5 million for payment related to exit costs, professional fees and other.

## 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.

The 12,000 employees provide a broad array of financial services to individual and business customers through hundreds of offices located in 47 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 which was included in the Retail/Commercial Banking segment was accounted for as a discontinued operation.

§ Mortgage Banking helps provide home ownership through First Horizon Home Loans, which operates offices in 46 states and is one of the top 20 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 traditional capital markets securities activities, structured finance, equity research, investment banking, loan sales, portfolio advisory, and the sale of bank-owned life insurance.

§ 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, revenue and expense associated with deferred compensation plans, 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 six-month periods ended June 30, 2007, compared to the three-month and six-month periods ended June 30, 2006. 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 2006 financial statements, notes, and MD&A is provided in the 2006 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 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 Second Quarter 2007 to Second Quarter 2006)**

### **FINANCIAL HIGHLIGHTS**

Earnings for second quarter 2007 were \$22.2 million or \$.17 per diluted share. In March 2007, FHN began Phases 2 and 3 of an ongoing, company-wide review of business practices with the goal of improving the FHN's overall profitability and productivity. As a result of actions taken in the second quarter of 2007, FHN recorded pretax expenses of \$39.3 million. These initiatives include:

- Organizational and compensation changes for right sizing operating segments and consolidating functional areas
  - Procurement centralization and multi-sourcing back office functions
- Repositioning non-core businesses including redesigning non-prime mortgage origination business and the exit of the collectible coin merchandising business
  - Other efforts, including facilities consolidation and divesting certain loan portfolios

The retail/commercial bank continues to invest in the state of Tennessee while Mortgage Banking experienced an increase in production, but was negatively impacted by gain on sale margins. The provision for loan losses increased as nonperforming assets increased compared to second quarter 2006. FHN was also impacted this quarter by legal settlements which resulted in a \$5.4 million net reduction in pre-tax earnings.

Return on average shareholders' equity and return on average assets were 3.6 percent and .23 percent, respectively, for second quarter 2007. Return on average shareholders' equity and return on average assets were 17.4 percent and 1.09 percent, respectively, for second quarter 2006. Total assets were \$38.4 billion and shareholders' equity was \$2.5 billion on June 30, 2007, compared to \$37.5 billion and \$2.4 billion, respectively, on June 30, 2006.

### **BUSINESS LINE REVIEW**

### **Retail/Commercial Banking**

Pre-tax income for Retail/Commercial Banking was \$81.5 million for second quarter 2007 compared to \$113.4 million for second quarter 2006. Total revenues for Retail/Commercial Banking were \$324.6 million for second quarter 2007 compared to \$346.5 million for second quarter 2006.

Net interest income was \$218.0 million in second quarter 2007 compared to \$232.5 million in second quarter 2006. The Retail/Commercial Banking net interest margin was 3.89 percent in second quarter 2007 compared to 4.31 percent in the second quarter of last year. This compression resulted from the contracting housing market which created competitive pricing pressure and additional nonaccrual construction loans. Also unfavorably impacting the margin were higher deposit rates paid in Tennessee markets.

Noninterest income was \$106.6 million in second quarter 2007 compared to \$114.0 million in second quarter 2006. This decrease primarily resulted as revenues from insurance commissions declined \$4.9 million due to the sale of two insurance subsidiaries in third quarter 2006. Revenue from loan sales and securitizations decreased \$2.9 million, or 27 percent, primarily due to a decline in the volume of loans delivered into the secondary markets.

Provision for loan losses increased to \$36.8 million in second quarter 2007 from \$18.3 million last year. The \$18.5 million increase primarily reflects deterioration in both homebuilder and one-time close construction loans.

Noninterest expense decreased 4 percent to \$206.3 million in second quarter 2007 from \$214.8 million last year. A previously identified pool of construction loans in which certain misrepresentations had been made resulted in a \$7.9 million negative impact on noninterest expense in second quarter 2006.

### **Mortgage Banking**

Mortgage Banking had a pre-tax loss of \$16.1 million in second quarter 2007, compared to pre-tax gain of \$29.7 million in second quarter 2006. Total revenues for Mortgage Banking were \$99.4 million for second quarter 2007 compared to \$145.1 million for second quarter 2006.

Net interest income was \$24.4 million in second quarter 2007 compared to \$25.5 million in second quarter 2006. The yield curve resulted in compression of the spread on the warehouse, which was 1.14 percent in second quarter 2007 compared to 1.44 percent for the same period in 2006. Additionally, a 2 percent decline in the warehouse negatively impacted net interest income. During the second quarter 2007, net interest income was favorably impacted by \$5.4 million due to the reclassification of \$175 million from excess mortgage servicing rights to trading securities. This reclassification was the outcome of capital management initiatives which resulted in modification of the Pooling and Servicing Agreements (PSA) for private (non-GSE) securitizations which were active as of March 31, 2007. The modifications separated master servicing from retained yield. Offsetting the increase in net interest income was a decline in servicing fees and a decline in the change of mortgage servicing rights (MSR) value due to runoff.

Noninterest income was \$75.0 million in second quarter 2007 compared to \$119.6 million in second quarter 2006. 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 MSR net of hedge gains or losses.

Net origination income declined to \$67.3 million in second quarter 2007 compared to \$110.4 million last year as loans delivered into the secondary market were flat at \$7.4 billion and the margin on deliveries decreased from 126 basis points in second quarter 2006 to 76 basis points in 2007. Total mortgage servicing fees decreased 8 percent to \$73.9 million from \$80.2 million primarily reflecting the change in PSA.



Servicing hedging activities and changes other than runoff in the value of capitalized servicing assets negatively impacted net revenues by \$6.0 million this quarter as compared to a year ago due to interest rate volatility, fluctuations in MSR values, higher cost to hedge, and the aforementioned change in PSA. Additionally, the change in MSR value due to runoff was \$62.7 million in second quarter 2007 compared to \$72.3 million last year primarily due to the change in PSA.

Noninterest expense was \$115.6 million in second quarter 2007 compared to \$115.1 million in second quarter 2006. Second quarter 2007 included \$8.4 million of increased expense related to a previously disclosed legal settlement as a higher number of claims were received by the end of the claims period than projected.

### **Capital Markets**

Capital Markets pre-tax earnings were \$12.7 million in second quarter 2007 compared to \$15.8 million in second quarter 2006. Total revenues for Capital Markets were \$86.6 million in second quarter 2007 compared to \$99.4 million in second quarter 2006. Net interest expense was \$3.9 million in second quarter 2007 compared to net interest expense of \$4.7 million in second quarter 2006.

Revenues from fixed income sales increased to \$48.3 million in second quarter 2007 from \$41.8 million in second quarter 2006, partially due to customer portfolio restructuring activities. Other product revenues were \$42.2 million in second quarter 2007, including \$3.0 million from a litigation settlement, compared to \$62.3 million in second quarter 2006. 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. The decrease from second quarter 2006 was primarily due to lower fees from structured finance and equity research activities. Other product revenues represented 47 percent and 60 percent of total product revenues in 2007 and 2006, respectively.

Noninterest expense was \$73.9 million in second quarter 2007 compared to \$83.6 million in second quarter 2006. This decrease was primarily due to efficiency initiatives and decreased variable compensation related to the decrease in product revenues.

### **Corporate**

The Corporate segment's results yielded a pre-tax loss of \$60.0 million in second quarter 2007 compared to a pre-tax loss of \$11.9 million in second quarter 2006. Results for the second quarter 2007 include \$39.3 million of expense associated with implementation of restructuring, repositioning and efficiency initiatives. See discussion of the restructuring, repositioning and efficiency initiatives below for further details. Also impacting results this quarter were net securities losses of \$1.1 million compared to \$2.9 million of net securities gains in second quarter 2006 related to the sale of MasterCard Inc. securities as MasterCard's initial public offering was completed.

### **RESTRUCTURING, REPOSITIONING, AND EFFICIENCY INITIATIVES**

In March 2007, FHN began Phases 2 and 3 of an ongoing, company-wide review of business practices with the goal of improving FHN's overall profitability and productivity. As a result of actions taken in the second quarter of 2007, FHN recorded pretax

expenses of \$39.3 million, including \$16.9 million of losses related to asset impairments. Expenses incurred in relation to the divestiture of a non-strategic loan portfolio are included in the provision for loan losses, while all other costs incurred in relation to the restructuring, repositioning, and efficiency initiatives implemented by management are included in noninterest expense. All costs associated with the initiatives implemented in the second quarter of 2007

are recorded as unallocated corporate charges within the Corporate segment. Significant expenses resulted from the following actions:

- Expense of \$8.0 million associated with organizational and compensation changes for right sizing operating segments and consolidating functional areas.
- Non-core business repositioning costs of \$17.0 million, including costs associated with the exit of the collectible coin merchandising business and the transition of the non-prime mortgage origination business to a broker model.
- Expense of \$14.3 million related to other restructuring, repositioning, and efficiency initiatives, including facilities consolidation, procurement centralization, multi-sourcing and the divestiture of certain loan portfolios.

Additional estimated pretax charges of up to \$60 million are anticipated to be recognized in relation to the continuing implementation of the currently identified restructuring, repositioning, and efficiency initiatives, through the targeted completion date for Phases 2 and 3 at the end of 2007. Settlement of the obligations arising from current initiatives will primarily occur in the third and fourth quarters of 2007 and will be funded from operating cash flows. Further, subsequent to the end of the second quarter of 2007, management decided to pursue the sale, closure or consolidation of 34 full-service First Horizon Bank branches in Atlanta, Baltimore, Dallas and Northern Virginia, while maintaining a national specialty banking focus in those areas. Charges in addition to those currently identified are anticipated as a result of this decision. At this time, the amounts and exact timing of additional charges cannot be reasonably estimated. As a result of implementing phases 2 and 3 of the restructuring, repositioning, and efficiency initiatives, it is anticipated that approximately \$125 million in profitability improvements should be experienced by the first quarter of 2008. Due to the nature of the actions being taken, several components of income and expense will be affected.

Charges related to restructuring, repositioning, and efficiency initiatives for the three months ended June 30, 2007, are presented in the following table based on the income statement line item affected. See Note 12 – Restructuring, Repositioning and Efficiency Charges for additional information.

**Table 1 - Charges for Restructuring, Repositioning, and Efficiency Initiatives**

	Three Months Ended June 30 2007
<i>(Dollars in thousands)</i>	
Provision for loan losses	\$ 7,672
Noninterest expense:	
Employee compensation, incentives and benefits	7,997
	3,726
Occupancy	
Equipment rentals, depreciation and maintenance	5,221
All other expense	14,702
Total noninterest expense	\$ 31,646
Loss before income taxes	\$ 39,318

### **INCOME STATEMENT REVIEW**

Total revenues (net interest income and noninterest income) were \$519.8 million in second quarter 2007 compared to \$588.6 million in 2006. Net interest income was \$239.5 million in second quarter 2007 compared to \$253.6 million in 2006 and noninterest income was \$280.3 million in 2007 compared to \$335.0 million in 2006. A discussion of the major line items follows.

### **NET INTEREST INCOME**

Net interest income decreased 6 percent to \$239.5 million in second quarter 2007. Earning assets grew 1 percent to \$34.3 billion and interest-bearing liabilities grew 2 percent to \$29.6 billion in second quarter 2007.

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 2.79 percent for second quarter 2007 compared to 2.99 percent for second quarter 2006. This compression in the margin occurred as the net interest spread decreased to 2.13 percent from 2.34 percent in 2006 while the impact of free funding increased from 65 basis points to 66 basis points. The decline in margin is primarily attributable to competitive pricing pressure in a contracting housing market, additional nonaccrual construction loans and higher deposit rates in Tennessee markets. The margin was also unfavorably affected by 7 basis points resulting from an adjustment of loan origination deferrals. The change in PSA described above had a positive impact on the margin this quarter. Additionally, the yield curve resulted in compression of the spread on the warehouse, which decreased 30 basis points to 1.14 percent in second quarter 2007.

**Table 2 - Net Interest Margin**

	Three Months Ended June 30	
	2007	2006
<b>Consolidated yields and rates:</b>		
Loans, net of unearned income	7.43%	7.36%
Loans held for sale	6.45	6.58
Investment securities	5.55	5.52
Capital markets securities	5.35	5.41
inventory		
Mortgage banking trading	12.13	10.20
securities		
Other earning assets	5.04	4.65
<b>Yields on earning</b>	<b>6.94</b>	<b>6.83</b>
<b>assets</b>		
Interest-bearing core deposits	3.39	2.90
Certificates of deposits \$100,000 and more	5.36	4.98
Federal funds purchased and securities sold under agreements to repurchase	4.99	4.68
Capital markets trading liabilities	5.43	5.84
Commercial paper and other short-term	5.14	4.97
borrowings		
Long-term debt	5.68	5.46
<b>Rates paid on interest-bearing</b>	<b>4.81</b>	<b>4.49</b>
<b>liabilities</b>		
<b>Net interest spread</b>	<b>2.13</b>	<b>2.34</b>
Effect of interest-free sources	.66	.65

**FHN -** **2.79%** 2.99%  
**NIM**

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

Given the current uncertainties in the financial markets, competitive pricing in the retail lending and deposit markets, and FHN's overall product mix, in the near term, the net interest margin is expected to be relatively stable or experience modest compression.

## NONINTEREST INCOME

### Mortgage Banking Noninterest Income

First Horizon Home Loans, a division of FTBNA, 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

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declined to \$67.3 million in second quarter 2007 compared to \$110.4 million last year as loans delivered into the secondary market were flat at \$7.4 billion and the margin on deliveries decreased from 126 basis points in second quarter 2006 to 76 basis points in 2007.

Servicing income includes servicing fees, changes in the fair value of the MSR asset and net gains or losses from hedging MSR. 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 decreased 8 percent to \$73.9 million from \$80.2 million primarily reflecting the change in PSA described in the Business Line Review.

Servicing hedging activities and changes other than runoff in the value of capitalized servicing assets negatively impacted net revenues by \$6.0 million this quarter as compared to a year ago due to interest rate volatility, fluctuations in MSR values, higher cost to hedge and the change in PSA described in the Business Line Review. Additionally, the change in MSR value due to runoff was \$62.7 million in second quarter 2007 compared to \$72.3 million last year primarily due to the change in PSA described in the Business Line Review.

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 3 - Mortgage Banking Noninterest Income**

Three Months Ended		Percent Change (%)	Six Months Ended		Percent Change (%)
June 30			June 30		
2007	2006		2007	2006	

**Noninterest income (thousands):**

Origination income	\$ 67,281	\$ 110,416	39.1	\$ 130,922	\$ 174,621	25.0
			-			-
Servicing income	(3,496)	(727)	NM	(488)	9,990	NM
			10.8			11.3
Other	7,515	6,783	+	13,963	12,543	+
Total mortgage banking noninterest income	\$ 71,300	\$ 116,472	38.8	\$ 144,397	\$ 197,154	26.8
			-			-

**Mortgage banking statistics (millions):**

Refinance originations	\$ 3,038.0	\$ 2,504.9	21.3	\$ 5,842.7	\$ 5,297.4	10.3
			+			+
Home-purchase originations	5,054.4	4,977.2	1.6	8,552.1	9,049.4	5.5
			+			-
Mortgage loan originations	\$ 8,092.4	\$ 7,482.1	8.2	\$ 14,394.8	\$14,346.8	0.3
			+			+
Servicing portfolio	\$105,652.0	\$99,304.4	6.4	\$105,652.0	\$99,304.4	6.4
			+			+

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

**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.

Revenues from fixed income sales increased \$6.4 million compared to second quarter 2006 partially due to customer portfolio restructuring activities. Other product revenues decreased \$23.4 million primarily due to lower fees from structured finance and equity research activities.

**Table 4 - Capital Markets Noninterest Income**

<i>(Dollars in thousands)</i>	Three Months Ended			Six Months Ended		
	June 30		Growth	June 30		Growth
	2007	2006	Rate (%)	2007	2006	Rate (%)
<b>Noninterest income:</b>						
Fixed income	\$48,258	\$ 41,843	15.3 +	\$ 94,571	\$ 92,445	2.3 +
Other product revenue	36,796	60,322	39.0 -	77,596	102,578	24.4 -
Total capital markets noninterest income	\$85,054	\$102,165	16.7 -	\$172,167	\$195,023	11.7 -

**Other Noninterest Income**

Other noninterest income includes deposit transactions and cash management fees, revenue from loan sales and securitizations, insurance commissions, trust services and investment management fees, net securities gains and losses and other noninterest income. Revenue from loan sales and securitizations decreased \$2.7 million, or 21 percent,

primarily due to a decline in the volume of loans delivered into the secondary markets. Insurance commissions decreased \$4.7 million, or 38 percent, primarily due to the divestiture of two subsidiaries in third quarter 2006. Second quarter 2007 results included \$1.1 million of net securities losses while second quarter 2006 results include \$2.9 million of net securities gains, primarily due to the sale of MasterCard Inc. securities. Other noninterest income increased \$18.8 million reflecting an increase of \$13.5 million in other revenues in 2007 related to deferred compensation plans, which is offset by a related increase in noninterest expense associated with these plans.

## NONINTEREST EXPENSE

Total noninterest expense for second quarter 2007 increased 8 percent to \$457.3 million from \$423.0 million in 2006. Employee compensation, incentives and benefits (personnel expense), the largest component of noninterest expense, increased to \$258.2 million from \$245.8 million in 2006. Included in these results was an increase of \$17.6 million in 2007 related to deferred compensation plans. Additionally impacting compensation, incentives and benefits were \$8.0 million of restructuring, repositioning and efficiency charges. These increases were partially offset by a continued corporate focus on efficiency and reductions in personnel expense in mortgage banking and capital markets directly related to the contraction in revenue. Increases in occupancy of \$5.9 million and equipment rentals, depreciation and maintenance of \$4.0 million are primarily related to restructuring, repositioning and efficiency charges. All other noninterest expense increased 15 percent, or \$14.5 million, from 2006 levels due to restructuring, repositioning and efficiency charges and \$8.4 million of increased expense related to a previously disclosed legal settlement as a higher number of claims were received by the end of the claims period than projected. In 2006, all other expense included \$7.9 million related to a previously identified pool of construction loans in which certain misrepresentations had been made.

## INCOME TAXES

The effective tax rate for second quarter 2007 was predominantly due to the effect of permanent items and the level of pre-tax income for the quarter. The provision for income taxes also reflects \$3.1 million for the favorable resolution of outstanding federal and state issues including interest with taxing authorities.

## 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 \$44.4 million in second quarter 2007 compared to \$18.6 million in second quarter 2006. Excluding the impact of the sold loans described in the Business Line Review for the quarter, the provision for loan losses increased \$18.1 million, reflecting deterioration in both homebuilder and one-time close construction portfolios related to the general downturn in the housing industry. The net charge-off ratio increased to 41 basis points in second quarter 2007 from 26 basis points in second quarter 2006 as net charge-offs grew to \$23.0 million from \$13.8 million, driven mainly by the maturation of the home equity portfolio and deterioration in the one-time close residential real estate portfolio.

**Table 5 - Net Charge-off Ratios \***

	Three Months Ended	
	June 30	
	2007	2006
Commercial	.32%	.32%
Retail real estate	.43	.13

Other retail	<b>2.76</b>	1.97
Credit card receivables	<b>3.16</b>	2.96
Total net charge-offs	<b>.41</b>	.26
* Net charge-off ratios are calculated based in average loans, net of unearned income. Table 7 provides information on the relative size of each loan portfolio.		

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Nonperforming loans in the loan portfolio were \$128.0 million on June 30, 2007, compared to \$61.4 million on June 30, 2006. The ratio of nonperforming loans in the loan portfolio to total loans was 57 basis points on June 30, 2007, and 28 basis points on June 30, 2006. The increase in nonperforming loans is attributable to deterioration in the one-time close and homebuilder portfolios, due primarily to the slowdown in the housing market. Nonperforming assets were \$194.1 million on June 30, 2007, compared to \$112.7 million on June 30, 2006. The nonperforming assets ratio was 81 basis points on June 30, 2007, and 45 basis points last year. In addition to the increase in nonperforming loans, foreclosed assets increased \$17.3 million, which can be attributed to the maturing of the home equity portfolio and the deterioration in the residential real estate loan portfolio. Foreclosed assets are written down to net realizable value at foreclosure. The nonperforming asset ratio is expected to remain under pressure throughout the balance of the negative housing cycle.

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### Table 6 - Asset Quality Information

<i>(Dollars in thousands)</i>	Second Quarter	
	2007	2006
<b>Allowance for loan losses:</b>		
Beginning balance on March 31	\$ 220,806	\$ 195,011
Provision for loan losses	44,408	18,653
Divestitures/acquisitions/transfers	(12,326)	-
Charge-offs	(26,493)	(17,518)
Recoveries	3,524	3,689
Ending balance on June 30	\$ 229,919	\$ 199,835
Reserve for off-balance sheet commitments	10,494	9,250

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Total allowance for loan losses and reserve for off-balance sheet commitments	\$ 240,413	\$ 209,085
	June 30	
	2007	2006
<b>Retail/Commercial Banking:</b>		
Nonperforming loans	\$ 128,025	\$ 61,358
Foreclosed real estate	36,635	24,425
Total Retail/Commercial Banking	164,660	85,783
<b>Mortgage Banking:</b>		
Nonperforming loans - held for sale	12,484	14,976
Foreclosed real estate	16,953	11,899
Total Mortgage Banking	29,437	26,875
Total nonperforming assets	\$ 194,097	\$ 112,658
Total loans, net of unearned income	\$ 22,382,303	\$ 21,717,264
Insured loans	(986,893)	(753,116)
Loans excluding insured loans	\$ 21,395,410	\$ 20,964,148
Foreclosed real estate from GNMA loans	\$ 13,910	\$ 24,253
Potential problem assets*	149,335	153,508
Loans 30 to 89 days past due	179,617	78,447
Loans 30 to 89 days past due - guaranteed portion**	50	79
Loans 90 days past due	34,462	26,841
Loans 90 days past due - guaranteed portion**	181	619
Loans held for sale 30 to 89 days past due	26,457	34,194
Loans held for sale 30 to 89 days past due - guaranteed portion**	19,755	28,732
Loans held for sale 90 days past due	136,565	138,918
Loans held for sale 90 days past due - guaranteed portion**	130,677	135,910
Off-balance sheet commitments***	7,201,579	7,305,293
Allowance to total loans	1.03%	.92%
Allowance to loans excluding insured loans	1.07	.95
Allowance to nonperforming loans in the loan portfolio	180	326
Nonperforming assets to loans, foreclosed real estate and other assets		
(Retail/Commercial Banking)	.75	.40
Nonperforming assets to unpaid principal balance of servicing portfolio (Mortgage Banking)	.03	.03
Allowance to annualized net charge-offs	2.50x	3.61x

\* Includes 90 days 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.

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

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 \$149.3 million on June 30, 2007, down from \$153.5 million on June 30, 2006. Also, loans 30 to 89 days past due increased to \$179.6 million on June 30, 2007, up from \$78.4 million on June 30, 2006. This significant increase was primarily driven by the slowdown in the housing market and its impact on homebuilder, one-time close, home equity, and permanent mortgage portfolios. The current expectation of losses from both potential problem assets and loans 30 to 89 days past 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 will primarily be driven by the length and breadth of the housing market cycle, the strength or weakness of the economies of the markets where FHN does business and early recognition and resolution of asset quality issues. In addition, asset quality ratios could be affected by balance sheet strategies and shifts in loan mix to and from products with different risk/return profiles. Asset quality indicators are expected to remain stressed during the remainder of the current housing industry cycle.

## **STATEMENT OF CONDITION REVIEW**

### **EARNING ASSETS**

Earning assets consist of loans, loans held for sale, investment securities, trading securities and other earning assets. During second quarter 2007, earning assets grew 1 percent and averaged \$34.3 billion compared to \$34.0 billion in 2006, as growth in loans and investment securities was offset by a decline in loans held for sale related to lower origination activity and other earning assets.

### **LOANS**

Average total loans increased 4 percent for second quarter 2007 to \$22.3 billion from \$21.4 billion in 2006. Average loans represented 65 percent of average earning assets in second quarter 2007 and 63 percent in 2006.

Commercial, financial and industrial loans increased 11 percent, or \$722.1 million, since second quarter 2006 reflecting increased market share in Tennessee, expansion in other markets, and continued economic growth. Commercial construction loans grew 23 percent since second quarter 2006 or \$539.1 million primarily due to growth in lending to homebuilders. It is important to note that significant growth in this portfolio occurred during 2006. Even though FHN experienced growth in 2007, its slowdown can be attributed to weakening industry demand, FHN becoming more selective of loans, and curtailment of the opening of new offices. Total retail loans decreased 4 percent or \$396.8 million reflecting a decline in home equity loans that was primarily due to the strategy of selling a significant portion of production to third party investors, and a slow down in the growth of one-time close loans that was due to a decrease in market demand and tighter underwriting standards (including real estate loans pledged against other collateralized borrowings). Additional loan information is provided in Table 7 – Average Loans.

FHN has a significant concentration in loans secured by real estate, which is geographically diversified nationwide. In 2007 and 2006, 65 percent and 67 percent, respectively, of total loans are secured by real estate (see Table 7). Three lending products have contributed to this level of real estate lending including significant levels of retail residential real estate, which comprise 35 percent of total loans. Also contributing to the level of real estate lending are commercial construction loans, which include loans to single-family builders and comprise 13 percent of total loans, and retail construction loans, First Horizon Home Loan's one-time close product, which comprises 9 percent of total loans. FHN's other commercial real estate lending, excluding single-family builders is well diversified by product type and industry. On June 30, 2007, FHN did not have any concentrations of 10 percent or more of commercial, financial and industrial loans in any single industry.

**Table 7 - Average Loans**

<i>(Dollars in millions)</i>				Three Months Ended June 30	
	2007	Percent Growth of Total		2006	Percent of Total
Commercial:					
Commercial, financial and industrial	\$ 7,292.4	33%	11.0%	\$ 6,570.3	31%
Real estate commercial	1,260.2	5	.1	1,259.4	6
Real estate construction	2,919.5	13	22.6	2,380.4	11
Total commercial	11,472.1	51	12.4	10,210.1	48
Retail:					
Real estate residential	7,854.8	35	(8.2)	8,560.1	40
Real estate construction	2,095.0	9	3.3	2,028.5	9
Other retail	150.0	1	(7.8)	162.6	1
Credit card receivables	194.7	1	(1.5)	197.7	1
Real estate loans pledged against other collateralized borrowings	543.8	3	90.0	286.2	1
Total retail	10,838.3	49	(3.5)	11,235.1	52
Total loans, net of unearned	\$ 22,310.4	100%	4.0%	\$ 21,445.2	100%

Commercial and retail loan growth should be primarily driven by the national sales platform and market conditions.

#### LOANS HELD FOR SALE

Loans held for sale consist of first-lien mortgage loans (warehouse), HELOC, second-lien mortgages, student loans, and small issuer trust preferred securities. The mortgage warehouse accounts for the majority of loans held for sale. Loans held for sale decreased 11 percent to \$4.1 billion in 2007 from \$4.6 billion in 2006. This decline is related to the lower demand for HELOC reflecting the soft housing market and a decline in small issuer trust preferred securities. FHN continues to fund loan originations and manage liquidity position through whole-loan sales and securitizations.

#### DEPOSITS / OTHER SOURCES OF FUNDS

Core deposits increased 4 percent to \$13.6 billion in second quarter 2007 compared to \$13.1 billion in 2006, primarily due to growth in Retail/Commercial Banking deposits reflecting market share gains in Tennessee markets and growth in the developing national markets. Short-term purchased funds averaged \$14.9 billion for second quarter 2007, down 7 percent or \$1.1 billion from second quarter 2006. In second quarter 2007, short-term purchased funds accounted for 43 percent of FHN's total funding down from 47 percent in second quarter 2006, 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 \$6.4 billion in second quarter 2007 compared to \$5.2 billion in second quarter 2006.

#### FINANCIAL SUMMARY(Comparison of first six months of 2007 to first six months of 2006)

Earnings were \$92.7 million or \$.72 per diluted share for the six months ended June 30, 2007. Earnings were \$319.3 million or \$2.49 per diluted share for the six months ended June 30, 2006, including the impact of the divestiture of FHN's national merchant processing business. For the six months ended June 30, 2007, return on average shareholders'

equity and return on average assets were 7.55 percent and .48 percent, respectively. Return on average shareholders' equity and return on average assets were 27.2 percent and 1.69 percent, respectively, for the six months ended June 30, 2006.

Comparisons between reported earnings are directly and significantly affected by a number of factors in both 2007 and 2006. See the Corporate segment discussion of the Business Line Review for the quarter for further details of the impact on 2007. FHN's year-to-date 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:

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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 \$77.4 million, predominantly related to repositioning approximately \$2.3 billion of investment securities.

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 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 continuing operations. FHN has subsequently redesignated these hedge relationships under SFAS No. 133 using the "long haul" method.

Various other items impacted results from continuing operations. In 2006, a pre-tax loss of \$12.7 million was recognized from the sale of home equity lines of credit (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 of \$13.8 million 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.

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 six months of 2007, total revenues were \$1,040.4 million, an increase of 1 percent from \$1,031.9 million in 2006. Noninterest income for the first six months of 2007 was \$563.5 million and contributed 54 percent to total revenues as compared to \$532.6 million, or 52 percent of total revenues in 2006.

Mortgage banking fee income decreased 27 percent to \$144.4 million from \$197.2 million. During this period, fees from the origination process decreased 25 percent to \$130.9 million from \$174.6 million for 2007 as loans sold into the secondary market decreased 6 percent and gain on sale margins declined.

Total mortgage servicing fees were flat or \$158.6 million in 2007 compared to \$158.1 million in 2006. Servicing net hedging activities and run-off of MSR values negatively impacted net servicing revenues in 2007 with a net loss of \$159.1 million as compared to a net loss of \$148.1 million in 2006. Specifically, significant flattening of the yield curve reduced net interest income derived from swaps utilized to hedge MSR. Consequently, the cost of hedging MSR increased in 2007 compared to 2006. The MSR value due to runoff negatively impacted servicing revenue by \$124.4 million in 2007 compared to \$130.9 million last year. Also impacting servicing fees and run-off of MSR in 2007 was the modification to the PSA mentioned in the quarterly Business Line Review. See Table 3 – Mortgage Banking Noninterest Income for a breakout of noninterest income as well as mortgage banking origination volume and servicing portfolio levels.

Fee income from capital markets decreased 12 percent to \$172.2 million from \$195.0 million for 2006 primarily due to decreased fees from investment banking and equity research activities, partially offset by an increase in loan sales and fixed income revenues. In 2007 net securities gains of \$9.2 million were primarily related to changes in the investment portfolio that were made to compensate for loan growth. Net securities losses of \$77.4 million in 2006 were primarily related to the restructuring of the investment portfolio in the first quarter 2006. Noninterest income from insurance commissions declined 36 percent or \$9.6 million due to the divestiture of two subsidiaries in third quarter 2006. Revenue from loan sales and securitizations decreased 18 percent

or \$4.3 million to \$19.3 million in 2007 primarily due to a decline in the volume of loans delivered into the secondary markets. Other noninterest income increased 51 percent, or \$33.4 million, to \$98.2 million. Other noninterest income in 2006 included the unfavorable adjustment of \$15.6 million previously mentioned. Other items impacting this growth were increases related to deferred compensation plans and increased levels of bank owned life insurance compared to 2006.

Net interest income decreased 5 percent to \$476.9 million from \$499.3 million for the first six months of 2007. The year-to-date consolidated margin decreased to 2.82 percent in 2007 from 2.99 percent in 2006. The reasons for the year-to-date trends were similar to the quarterly trend information already discussed.

Total noninterest expense for the first six months of 2007 increased to \$860.3 million from \$858.1 million in 2006. Employee compensation, incentives and benefits (personnel expense), occupancy and equipment rentals, depreciation and maintenance were impacted by restructuring, repositioning and efficiency initiatives previously discussed. These results also reflect reductions in personnel expense in mortgage banking and capital markets directly related to the contraction in revenue. All other expense categories increased 2 percent or \$3.3 million in 2007. Expenses of \$14.7 million in 2007 were primarily related to the exit of the collectible coin merchandising business. In 2006 this category included expense growth in the collectible coin business, losses due to certain misrepresentations within a previously identified pool of construction loans, occupancy expense, dividends on

FTBNA perpetual preferred stock, nonprime mortgage loans, consolidating operations, closing offices, and technology. Excluding the impact of the sold loans described in the Business Line Review for the quarter, the provision for loan losses increased 79 percent to \$65.2 million from \$36.4 million in the first six months of 2007 primarily reflecting deterioration related to both homebuilder and one-time-close construction loans. See further discussion in the Asset Quality section of the MD&A.

## **BUSINESS LINE REVIEW**

### **Retail/Commercial Banking**

Total revenues for the six-month period were \$651.7 million, a decrease of 4 percent from \$680.0 million in 2006. Net interest income decreased 4 percent, or \$16.1 million. Noninterest income decreased 6 percent, or \$12.2 million from \$221.8 million in 2006. Revenue from insurance commissions declined \$9.8 million due to the sale of two insurance subsidiaries in third quarter 2006. Revenue from loans sales and securitizations declined \$2.6 million primarily due to a decline in the volume of loans delivered into the secondary markets. Provision for loan losses increased 80 percent in 2007 to \$65.3 million from \$36.3 million. The \$29.0 million increase primarily reflects an increase in nonperforming assets related to both homebuilder and one-time-close construction loans. Total noninterest expense for the six-month period decreased 7 percent to \$404.5 million from \$433.2 million in 2006. Total noninterest expense in 2006 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. For the first six months of 2007, pre-tax income decreased to \$181.9 million from \$210.5 million in 2006.

### **Mortgage Banking**

Total revenues for the six-month period were \$193.4 million, a decrease of 24 percent from \$254.7 million in 2006. During this period, fees from the origination process decreased \$43.7 million while net servicing income declined \$10.5 million. See Table 3 – Mortgage Banking Noninterest Income for a breakout of noninterest income as well as mortgage banking origination volume and servicing portfolio levels. Total noninterest expense for the six-month period decreased 4 percent to \$220.9 million from \$229.9 million in 2006. This decrease primarily reflects lower personnel expense related to the contraction in origination revenue and reductions in support headcount offset by the recognition of \$8.4 million of increased expense related to a previously disclosed legal settlement as a higher number of claims were received by the end of the claims period than projected. For the first six months of 2007 pre-tax income decreased to a loss of \$27.4 million from income of \$24.7 million in 2006.

### **Capital Markets**

Total revenues for the six-month period were \$169.7 million, a decrease of 11 percent from \$190.3 million in 2006. This decline was primarily due to decreases in investment banking and equity research activities partially offset by an increase in loan sales and fixed income revenues. For the first six months of 2007 pre-tax income decreased 33 percent to \$16.1 million from \$24.1 million in 2006.

### **Corporate**

For the first six months of 2007, Corporate had a pre-tax loss of \$63.4 million compared to a pre-tax loss of \$121.9 million in 2006. See restructuring, repositioning and efficiency initiatives previously discussed for further detail on the noninterest expense impact in 2007. Included in 2006 were net securities losses of \$77.4 million primarily related to the restructuring of the investment portfolio in first quarter 2006. 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.

**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 3 percent in second quarter 2007 to \$2.5 billion from \$2.4 billion, reflecting internal capital generation. Period-end shareholders' equity was \$2.5 billion on June 30, 2007, up 1 percent from the prior year. 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 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.

**Table 8 - 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>2007</b>				
April 1 to April 30	9	\$ 39.79	9	30,402
May 1 to May 31	*	40.33	*	30,402
June 1 to June 30	-	-	-	30,402
<b>Total</b>	<b>9</b>	<b>\$ 39.79</b>	<b>9</b>	

\* Amount is less than 1,000 shares

**Compensation Plan Programs:**

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A consolidated compensation plan share purchase program 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 June 30, 2007, the maximum number of shares that may be purchased under the program was 28.8 million shares.

**Other Programs:**

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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 June 30, 2007, the maximum number of shares that may be purchased under the program was 1.6 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 June 30, 2007, FHN and FTBNA had sufficient capital to qualify as well-capitalized institutions as shown in Note 6 – 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

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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, Regulatory Compliance Committee, Operational Risk Committee, and the Executive Program Governance Forum. The Chief Credit Officer, EVP of Interest Rate Risk Management, Corporate Treasurer, EVP of Regulatory Risk Management, EVP of Risk Management, and EVP of Corporate Services chair these committees respectively. Reports regarding Credit, Asset/Liability Management, Market Risk, Capital Management, Regulatory Compliance, 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 evaluations are reviewed with management and the Audit Committee, as appropriate.

## **MARKET UNCERTAINTIES AND PROSPECTIVE TRENDS**

Given the significant current uncertainties in the mortgage and credit markets, it is anticipated that the second half of 2007 and 2008 will continue to be challenging for the housing markets and for FHN. Competitive pricing pressure is likely to continue related to mortgage (first- and second-lien) gain on sale margins. In addition, current volatility and reduced liquidity in the capital markets may adversely impact market execution putting further pressure on margins as well as revenues. Some improvement is anticipated once the market stabilizes. However, as difficulties in the

mortgage and credit markets persist, the compression of gain on sale margins may prompt changes in FHN's liquidity management strategies. Further deterioration of the housing market could result in increased credit costs depending on the length and depth of this market cycle.

### **INTEREST RATE RISK MANAGEMENT**

Interest rate risk is the risk that changes in prevailing interest rates will adversely affect assets, liabilities, capital, income and/or expense at different times or in different amounts. 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 associated earnings while operating within prudent risk limits and thereby preserving the value of FHN's capital.

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 loans and other assets do not necessarily match those of deposits, other borrowings and capital. To the extent that earning assets reprice more quickly than liabilities, this position should benefit net interest income in a rising interest rate environment and could negatively impact net interest income in a declining interest rate environment. In the case of floating rate assets and liabilities with similar repricing frequencies, FHN may also be exposed to basis risk, which results from changing spreads between earning and borrowing rates. Generally, when interest rates decline, Mortgage Banking faces increased prepayment risk associated with 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. As discussed in Critical Accounting Policies, derivative financial instruments are used by mortgage banking for two purposes. First, forward sales contracts and futures contracts are used to protect against changes in fair value of the pipeline and mortgage warehouse (refer to discussion of Pipeline and Warehouse under Critical Accounting Policies) from the time an interest rate is committed to the customer until the mortgage is sold into the secondary market due to increases in interest rates. Second, interest rate contracts are utilized to protect against MSR prepayment risk that generally accompanies declining interest rates. As interest rates fall, the value of MSR should decrease and the value of the servicing hedge should increase. The converse is also true.

Derivative instruments are also used to protect against the risk of loss arising from adverse changes in the fair value of capital markets' securities inventory due to changes in interest rates. FHN does not use derivative instruments to protect against changes in fair value of loans or loans held for sale other than the mortgage pipeline and warehouse.

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 or inverts. In addition, a flattening or inverted yield curve negatively impacts the demand for fixed income securities



and, therefore, Capital Markets' revenue.

## **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 (FHLB), 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 second quarter 2007 and 2006, the total loans, excluding loans held for sale and real estate loans pledged against other collateralized borrowings, to core deposits ratio was 160 percent and 161 percent, respectively. One means of maintaining a stable liquidity position is to sell loans either through whole-loan sales or loan securitizations. During 2007 and 2006, FHN sold loans through on-balance sheet securitizations structured as financings 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 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 June 30, 2007, \$1.7 billion was available under current conditions through the bank note program as a funding source.

FHN and FTBNA have the ability to generate liquidity by issuing preferred equity or incurring other debt. Liquidity has been obtained through FTBNA's issuance of approximately \$250 million of subordinated notes in 2006. FHN also evaluates alternative sources of funding, including loan sales, securitizations, syndications, and FHLB borrowings in its management of liquidity.

The Consolidated Condensed Statements of Cash Flows provide information on cash flows from operating, investing and financing activities for the six-month periods ended June 30, 2007 and 2006. For the six months ended June 30, 2007, negative cash flows from operating activities exceeded net cash provided by investing and financing activities primarily due to an increase in capital market receivables and loans held for sale. Positive investing cash flows resulted as \$.6 billion available for sale securities were sold in anticipation of loan growth. Cash flows from financing activities reflected a \$2.1 billion decrease in short-term borrowings as deposits and long-term borrowings, which increased \$1.5 billion and \$1.1 billion respectively, were utilized to fund the balance sheet. In 2006, significant cash flows from investing activities included the sale of \$2.3 billion investment securities and the subsequent purchase of \$2.9 billion investment securities as the portfolio was repositioned. Investing activities also provided a \$.4 billion increase in cash due to the merchant divestiture, of which \$.2 billion, the gain on the sale, is included in net income. The impacts to cash flows from loan growth and an increase in capital markets balances were largely offset by a decrease in loans held for sale. Cash flows from financing activities reflected a decrease of \$1.7 billion in deposits, primarily from certificates of deposit greater than \$100,000, as long term borrowings, which increased \$2.2 billion, were utilized to fund the balance sheet. Also included in cash flows from financing activities was a decrease of \$165.6 million related to the share repurchase.

Parent company liquidity is maintained by cash flows stemming from dividends and interest payments collected from subsidiaries along with net proceeds from stock sales through employee plans, which represent the primary sources of funds to pay dividends to shareholders and interest to debt holders. The amount paid to the parent company through FTBNA common dividends is managed as part of FHN's overall cash management process, subject to applicable regulatory restrictions described in the next paragraph. The parent company also has the ability to enhance its liquidity position by raising equity or incurring debt. In addition, \$50 million of borrowings under an unsecured line of credit from non-affiliated banks was available to the parent company to provide for general liquidity needs.

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Certain regulatory restrictions exist regarding the ability of FTBNA to transfer funds to FHN in the form of cash, common dividends, loans or advances. At any given time, the pertinent portions of those regulatory restrictions allow FTBNA to declare preferred or common dividends without prior regulatory approval in an amount equal to FTBNA's retained net income for the two most recent completed years plus the current year to date. For any period, FTBNA's 'retained net income' is equal to FTBNA's regulatory net income reduced by the preferred and common dividends declared by FTBNA. One effect of this regulatory calculation method is that the amount available for preferred or common dividends by FTBNA without prior regulatory approval often changes substantially at the beginning of each new fiscal year compared with the last day of the year just completed. FTBNA's total amount available for dividends was \$642.7 million at December 31, 2006, and was reduced substantially at January 1, 2007 because in 2007 the regulatory calculation method no longer included the \$344.4 million of retained net income associated with the year 2004. Earnings (or losses) and dividends in 2007 have changed and will continue to change the amount available during the year until December 31. Another reduction will occur at January 1, 2008 with respect to \$225.0 million of retained net income for the year 2005, and again at January 1, 2009 with respect to \$73.3 million of retained net income for the year 2006.

#### **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 second quarter 2007, approximately \$4.8 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 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 an efficient way for FHN and other participants in the housing industry to monetize these assets. On June 30, 2007 and 2006, the outstanding principal amount of loans in these off-balance sheet business trusts was \$25.7 billion and \$22.7 billion, respectively. 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**

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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.

### **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.

### **COMPLIANCE RISK MANAGEMENT**

Compliance risk is the risk of legal or regulatory sanctions, material financial loss, or loss to reputation as a result of failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to banking and other activities. Management, measurement, and reporting of compliance risk are overseen by the Regulatory Compliance Committee, which is chaired by the EVP of Regulatory Risk Management. Key executives from the business segments, legal, risk management, and shared services are represented on the committee. Summary reports of the committee's activities and decisions are provided to the Enterprise-wide Risk/Return Management Committee, and to the Audit Committee of the Board, as applicable. Reports include the status of regulatory activities, internal compliance program initiatives, and evaluation of emerging compliance risk areas.

## **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.

## **CRITICAL ACCOUNTING POLICIES**

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## **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) required 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 at current fair value. The changes in fair 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 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 9 - Mortgage Banking Prepayment Assumptions**

	Three Months Ended June 30	
	2007	2006
Prepayment speeds		
Actual	<b>18.1%</b>	18.3%
Estimated*	<b>16.1</b>	13.3

\* 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 a prominent independent 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 June 30, 2007 and 2006, 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) reviews the overall assessment of the estimated fair value of MSR monthly. The FHRMC is responsible for approving the critical assumptions used by management to determine the estimated fair value of First Horizon Home Loans' MSR. In addition, FHN's MSR Committee reviews the initial capitalization rates for newly originated MSR, the assessment of the fair value of MSR and the source of significant changes to the MSR carrying value each quarter.

### **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. 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 are recognized as a component of net servicing income in mortgage banking noninterest income. Successful economic hedging will help minimize earnings volatility that may result from 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

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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 and are legally separable from the base servicing rights. 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.

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**

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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.

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 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 \$2.6 billion and \$1.8 billion on June 30, 2007 and 2006, respectively. The balance sheet impacts of the related derivatives were net assets of \$20.0 million and \$7.8 million on June 30, 2007 and 2006, respectively. Net losses of \$1.6 million and \$10.4 million representing the ineffective portion of these fair value hedges were recognized as a component of gain or loss on sale of loans for the six months ended June 30, 2007 and 2006, respectively.

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. 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 June 30, 2007 and 2006, 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 an asset with an estimated fair value of \$11.4 million and a liability with an estimated fair value of \$14.0 million on June 30, 2007, compared to an asset with an estimated fair value of \$8.2 million and a liability with an estimated fair value of \$6.7 million on June 30, 2006.

## **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 June 30, 2007 and 2006, \$3.2 billion and \$2.9 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 June 30, 2007 and 2006, \$4.8 billion and \$5.3 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 June 30, 2007 and 2006, \$110.5 million and \$146.2 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 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 June 30, 2007 and 2006, the foreclosure reserve was \$14.6 million and \$15.1 million, respectively. While the servicing portfolio has grown from \$99.3 billion on June 30, 2006, to \$106.0 billion on June 30, 2007, the foreclosure reserve has decreased primarily due to the decline in the limited and full recourse portfolios.

## **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.

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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 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 June 30, 2007 and 2006.

#### **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, 2006, 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, 2006, 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. 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 June 2007, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position 07-1, "Clarification of the Scope of the Audit and Accounting Guide *Investment Companies* and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies" (SOP 07-1), which provides guidance for determining whether an entity is within the scope of the AICPA's Investment Companies Guide. Additionally, SOP 07-1 provides certain criteria that must be met in order for investment company accounting applied by a subsidiary or equity method investee to be retained in the financial statements of the parent company or an equity method investor. SOP 07-1 also provides expanded disclosure requirements regarding the retention of such investment company accounting in the consolidated financial statements. In May 2007, FASB Staff Position No. FIN 46(R)-7, "Application of FASB Interpretation No. 46(R) to Investment Companies" (FIN 46(R)-7) was issued. FIN 46(R)-7 amends FIN 46(R) to provide a permanent exception to its scope for companies within the scope of the revised Investment Companies Guide under SOP 07-1. SOP 07-1 and FIN 46(R)-7 are effective for fiscal years beginning on or after December 15, 2007. FHN is currently assessing the financial impact of adopting SOP 07-1 and FIN 46(R)-7.

In April 2007, FASB Staff Position No. FIN 39-1, "Amendment of FASB Interpretation No. 39" (FIN 39-1) was issued. FIN 39-1 permits the offsetting of fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral against fair value amounts recognized for derivative instruments executed with the same counterparty under the same master netting arrangement. Upon adoption of FIN 39-1, entities are permitted to change their previous accounting policy election to offset or not offset fair value amounts recognized for derivative instruments under master netting arrangements. Additionally, FIN 39-1 requires additional disclosures for derivatives and collateral associated with master netting arrangements. FIN 39-1 is effective for fiscal years beginning after November 15, 2007, through retrospective application, with early application permitted. FHN is currently assessing the financial impact of adopting FIN 39-1.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS No. 159), which allows an irrevocable election to measure certain financial assets and financial liabilities at fair value on an instrument-by-instrument basis, with unrealized gains and losses recognized currently in earnings. Under SFAS No. 159, the fair value option may only be elected at the time of initial recognition of a financial asset or financial liability or upon the occurrence of certain specified events. Additionally, SFAS No. 159 provides that application of the fair value option must be based on the fair value of an entire financial asset or financial liability and not selected risks inherent in those assets or liabilities. SFAS No. 159 requires that assets and liabilities which are measured at fair value pursuant to the fair value option be reported in the financial statements in a manner that separates those fair values from the carrying amounts of similar assets and liabilities which are measured using another measurement attribute. SFAS No. 159 also provides expanded disclosure requirements regarding the effects of electing the fair value option on the financial statements. SFAS No. 159 is effective prospectively for fiscal years beginning after November 15, 2007. FHN is currently assessing the financial impact of adopting SFAS No. 159.

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

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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 regarding the effects of fair value measurements on the financial statements. SFAS No. 157 is effective prospectively for fiscal years beginning after November 15, 2007. FHN is currently assessing the financial impact of adopting SFAS No. 157.

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 because such obligations are not considered to be 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 undivided profits. FHN is currently assessing the financial impact of adopting EITF 06-4.

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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 28-53, (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 2006 Annual Report to shareholders, and (c) the "Interest Rate Risk Management" subsection of Note 25 to the Consolidated Financial Statements included in FHN's 2006 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.

### Item 4(T). Controls and Procedures

Not applicable

Part II.

OTHER INFORMATION

Items 1, 3, and 5

As of the end of the second quarter 2007, the answers to Items 1, 3, and 5 were either inapplicable or negative, and therefore, these items are omitted.

Item 1A Risk Factors

In 2007 the Corporation has announced several initiatives to restructure, reposition, expand, and otherwise alter its business operations in several respects. Many of those changes have not been implemented and the planning process is not yet complete. However, at the present time the Corporation is able to identify certain changes to its previous disclosures concerning risk factors.

The discussion concerning "Growth Risks" in Item 1A of the Corporation's annual report on Form 10-K for the year 2006 is amended and restated as follows:

Growth Risks

Every organization faces risks associated with growth. Our growth in recent years has resulted primarily from a combination of: our expansion strategy in banking; acquisition of customers from competitors that have merged with each other; and targeted non-bank business acquisitions. In 2007 we modified our banking growth strategy and determined to expand our capital markets business by opening Asian offices.

Our banking growth strategy at present is to leverage our national mortgage business by selling various banking products to mortgage customers, and to invest capital and other resources primarily in our current Tennessee-based market footprints. At the present time we no longer are pursuing a strategy of offering full-service banking in local brick-and-mortar branches to customers outside of our Tennessee market areas. Banking growth has been and continues to be primarily organic rather than through substantial acquisitions. We believe that the successful execution of our banking growth strategy depends upon a number of key elements, including:

- our ability to cross-sell our home mortgage customers into bank products and services;
- our ability to attract and retain banking customers in our Tennessee market areas;
- our ability to develop and retain profitable customer relationships while expanding our existing information processing, technology, and other operational infrastructures effectively and efficiently; and
- our ability to manage the liquidity and capital requirements associated with organic growth.

We have in place a number of strategies designed to achieve each of those elements. Our challenge is to execute those strategies and adjust them as conditions change.

To the extent we engage in bank or non-bank business acquisitions, we face various risks associated with that practice, including:

our ability to identify, analyze, and correctly assess the contingent risks in the acquisition and to price the transaction appropriately;

- our ability to integrate the acquired company into our operations quickly and cost-effectively;
- our ability to integrate the name recognition and goodwill of the acquired company with our own; and,
- our ability to retain customers and key employees of the acquired company.

To grow effectively, sometimes a company must consider disposing of or otherwise exiting businesses or units that no longer fit into management's plans for the future. Key risks associated with dispositions and closures include:

- our ability to price a sale transaction appropriately and otherwise negotiate appropriate terms;

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our ability to identify and implement key customer and other transition actions to avoid or minimize negative effects on retained businesses; and

our ability to assess and manage any loss of synergies that the disposed or exited business had with our retained businesses.

The discussion concerning "Geographic Risks" in Item 1A of the Corporation's annual report on Form 10-K for the year 2006 is amended and restated as follows.

#### Geographic Risks

Our mortgage and capital markets businesses are national in scope, and capital markets is developing internationally. Our banking growth strategy has expanded our banking business beyond our Tennessee market areas, with various banking products being sold through mortgage offices across the U.S. Nevertheless, most of our traditional banking business remains grounded in, and depends upon, the major Tennessee markets. As a result, to a greater degree than many of our competitors that operate nationally or in much broader regions, our banking business currently is exposed to adverse economic, regulatory, natural disaster, and other risks that might primarily impact Tennessee and the mid-South region of the U.S.

The following information supplements the discussion in Item 1A of the Corporation's annual report on Form 10-K for the year 2006:

#### Non-US Operations Risks

In 2007 we determined to expand our capital markets business by opening two Asian offices, our first offices outside of the United States. Opening and operating non-US offices creates a number of new risks. Specific risks associated with any non-US presence include: the risk that taxes, licenses, fees, prohibitions, and other barriers and constraints may be created or increased by the U.S. or other countries that would impact our ability to operate overseas profitably or at all; the risk that our assets and operations in a particular country could be nationalized in whole or part without adequate compensation; the risk that currency exchange rates could move unfavorably so as to diminish or destroy the US dollar value of assets, or to enlarge the US dollar value of liabilities, denominated in those currencies; and the risk that political or cultural preferences in a particular host country might become antagonistic to US companies. Our ability to manage those and other risks will depend upon a number of factors, including: our ability to recognize and anticipate differences in cultural and other expectations applicable to customers, employees, regulators, and vendors and other business partners; our ability to recognize and act upon opportunities and constraints peculiar to the countries and cultures in which our offices operate; our ability to recognize and manage any exchange rate risks to



which we are exposed; and our ability to anticipate the stability of or changes in the political, legal, and monetary systems of the countries in which our offices operate.

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

(a) On March 1, 2005, FHN purchased all of the outstanding stock of Greenwich Home Mortgage Corporation. A portion of the total purchase price was paid to ten shareholders of Greenwich in the form of a total of 90,867 shares of FHN's common stock, par value of \$0.625 per share, inclusive of shares issued into escrow accounts established under the acquisition agreement. The agreement calls for possible additional shares to be issued over certain periods based on certain actions or results (collectively, "adjustment shares"). There was no underwriter associated with the privately negotiated transaction. The issuance of FHN shares in connection with the transaction was and is exempt from registration pursuant, among other things, to Section 4(2) of the Securities Act of 1933, as amended. In May 2007, a total of 1,358 escrow shares were distributed to Greenwich shareholders pursuant to the agreement, representing the final distribution from the escrow accounts. Adjustment shares were not issued during the quarter, but may be issued in the future under the agreement.

(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 41.

Item 4 Submission of Matters to a Vote of Securities Holders

(a) The Company’s annual meeting of shareholders was held on April 17, 2007.

(b) Proxies for the annual meeting were solicited in accordance with Regulation 14A under the Securities Exchange Act of 1934. There was no solicitation in opposition to management’s three Class II and one Class I nominees listed in the proxy statement: Robert C. Blattberg; Michael D. Rose; Luke Yancy III; and (in Class I) Gerald L. Baker. All of management’s nominees were elected. Seven Class I and Class III directors continued in office: R. Brad Martin; Vicki R. Palmer; William B. Sansom; Simon F. Cooper; James A. Haslam, III; Colin V. Reed; and Mary F. Sammons.

(c) In addition to the election of directors, the shareholders approved the 2002 Management Incentive Plan, as amended, and ratified the appointment of KPMG LLP as independent auditor for the year 2007. The specific shareholder vote related to the election, approval, and ratification items is summarized below:

<u>Vote Item</u>	<u>Nominee</u>	<u>For</u>	<u>Withheld</u>	<u>Abstain</u>	<u>Broker Nonvote</u>
1. Election of Directors	Robert C. Blattberg	104,540,422	3,019,169	0	0
	Michael D. Rose	103,626,014	3,933,577	0	0
	Luke Yancy III	104,703,180	2,856,411	0	0
	Gerald L. Baker	104,052,739	3,506,852	0	0

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<u>Vote Item</u>	<u>Plan</u>	<u>For</u>	<u>Against</u>	<u>Abstain</u>	<u>Broker Nonvote</u>
2. Approval of Executive Comp. Plan	2002 Management Incentive Plan, as amended	101,089,306	4,593,603	1,876,682	0

<u>Vote Item</u>	<u>Auditor</u>	<u>For</u>	<u>Against</u>	<u>Abstain</u>	<u>Broker Nonvote</u>
3. Ratification of Auditor	KPMG LLP	105,054,621	1,580,356	924,614	0

(d)Not applicable.

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Item 6 Exhibits

(a) Exhibits.

<u>Exhibit No.</u>	<u>Description</u>
3.2	Bylaws of the Corporation, as amended and restated as of July 17, 2007, incorporated herein by reference to Exhibit 3.2 to the Corporation's Current Report on Form 8-K dated July 17, 2007.
4	Instruments defining the rights of security holders, including indentures.*
10.4(f)**	Form of Performance Stock Units Grant Notice [2007].
10.5(p)**	Form of Management Stock Option Grant Notice [2007].
10.6(c)**	Capital Markets Incentive Compensation Plan, incorporated herein by reference to Exhibit 10.6(c) to the Corporation's Quarterly Report on Form 10-Q for the period ended September 30, 2006. 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.
10.7(m)**	Conformed copy of offer letter concerning employment of D. Bryan Jordan (principal financial officer), incorporated herein by reference to Exhibit 10.7(m) to the Corporation's Current Report on Form 8-K dated April 13, 2007.
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 108 in the Corporation's 2006 Annual Report to shareholders furnished to shareholders in connection with the Annual Meeting of Shareholders on April 17, 2007, 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: August 7, 2007

By: /s/ D. Bryan Jordan

D. Bryan Jordan

Executive Vice President and Chief

Financial Officer (Duly Authorized

Officer and Principal Financial Officer)

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