# 2005 Annual Report

FIRST HORIZON
NATIONAL CORPORATION

# Who We Are

First Horizon National Corporation (NYSE:FHN) is a nationwide financial services corporation with a long history of success and traditions dating back to 1864. Today the company is known for a deep commitment to its employees and exceptional customer service. We are one of the nation's top 30 bank holding companies in asset size and have approximately 13,000 employees working in 46 states.

At year-end we had:

- $36.6 billion in assets
- $4.9 billion in market capitalization
- ROE of 20.4 percent
- ROA of 1.20 percent
- Five-year compounded annual EPS growth rate of 14 percent

In 2005 we continued to earn national recognition:

- Named one of the 100 Best Corporate Citizens by Business Ethics magazine for the third consecutive year
- Again named to the AARP Best Employers for Workers Over 50 list
- Earned 11th straight spot on Working Mother magazine's annual list of the 100 Best Companies for Working Mothers
- Inducted into Fortune magazine's Hall of Fame for earning a spot on its list of the 100 Best Companies to Work For since the list's inception in 1998

More information can be found at www.fhnc.com.

# What We Believe

## Our Vision

We aspire to be a premier national financial services company dedicated to creating the highest levels of value and producing long-term levels of industry-leading profitability and growth.

## Our Core Values

Employees first  We hire, retain and develop the best people, ensuring that every employee has the opportunity to demonstrate high performance and succeed. We nurture our employees as our competitive advantage.

Exceptional teamwork  As one enterprise, we exhibit an uncommon ability to work together, based on interdependence and trust.

Individual accountability  As owners, we take individual responsibility for our overall success.

Absolute determination  When we identify a goal, we are committed to meeting it. We execute with speed and diligence and take pride in going above and beyond.

Knowing our customers  We create value and build loyalty by understanding and exceeding the expectations of customers in our target markets.

Doing the right thing  We have the courage to make decisions and take actions based on personal and professional integrity.

# Chairman's Message

The highlight of 2005 was the continued exceptional growth of our retail/commercial bank, which produced 74 percent of our pretax earnings. The bank provided a stable stream of earnings and performed well in an interest rate environment that had a significant negative impact on two other major business lines, mortgage banking and capital markets, making it a struggle to experience overall earnings growth. We were able to grow marginally during the second half of the year, but in general, we battled through a very tough environment.

The highlight of 2005 was the continued exceptional growth of our retail/commercial bank, which produced 74 percent of our pretax earnings.

The Tennessee bank continued to leverage its leading market position in the state by expanding the sales force, adding new financial centers in Nashville and aggressively marketing to customers of merging banks. These efforts produced 75 basis points of market share gains for the year in both the retail and commercial markets.

Our national expansion strategy also worked well. The cross-sell penetration of retail mortgage customers who purchased additional banking products increased 3 percentage points from year-end 2004 to 38 percent by year-end 2005. Additionally, we expanded our full-service banking presence in Virginia, Texas and Georgia, opening 13 new financial centers and acquiring two full-service centers with the purchase of West Metro Financial Services Inc. in Georgia. This expansion more than tripled our deposits in those markets in excess of $350 million. First Horizon is now doing business in more than 500 offices in 46 states.

In the mortgage business, our home purchase originations grew 13 percent faster than the national market in 2005, largely due to a sales force increase of 9 percent. And mortgage servicing portfolio profitability continued to improve, as the servicing cost per loan declined by 10 percent and impairment costs subsided.

Capital markets saw its revenues decline for most of 2005 as the flattening yield curve made fixed income investors hesitant to purchase securities. However, the fourth quarter's fixed income revenues equaled the previous quarter's for the first time since the Fed began to increase rates. We view that as a potential sign of stabilization. In addition, our capital markets business achieved a 10 percent increase in its revenues from products and services other than fixed income in 2005. Those other revenues came primarily from investment banking, equity research and loan sales.

As shareholders, I'm sure we shared the frustration of the market's response to our 2005 results. But looking at 2006, I'm encouraged about the opportunities that exist in our businesses and the progress we are making toward our commitment of $50 million in earnings enhancements. We have an outstanding team of managers and employees that has been successfully executing our strategies. I'm confident that will continue this year. A large unknown, of course, is the shape of the yield curve. Until the yield curve steepens, we will depend on earnings enhancements, coupled with a continued strong performance from the retail/commercial bank, to offset the negative environment and to provide earnings growth. When the yield curve environment improves, our earnings growth will accelerate and our shareholders will be rewarded for their patience.

> As I look at 2006, I'm encouraged about the opportunities that exist in our businesses and the progress we are making toward our commitment of $50 million in earnings enhancements.

Ken Glass

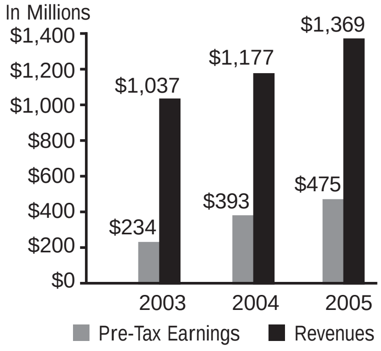
*Chairman of the Board*
*President and*
*Chief Executive Officer*

February 1, 2006

# What We Do

All Things Financial® is our nationwide financial services trademark and sums up our strategy of offering a broad selection of products and services through our three major business segments – retail/commercial banking, mortgage banking and capital markets. We believe our major business segments strategically complement each other. Even though each is impacted by market fluctuations, when one business line experiences challenges, another should be strong. It is the combination of these three businesses and the hard work of our employees that give us a competitive advantage.

## Retail/Commercial Banking



First Tennessee Bank is the brand we operate under in Tennessee. Outside Tennessee we operate as First Horizon Bank.

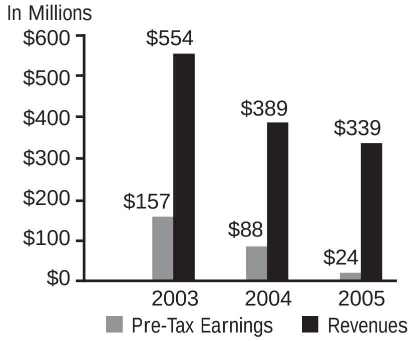
We have the most loyal customer base in Tennessee and one of the highest customer retention rates of any bank in the country.

We are a full-service provider of business and consumer financial services offering deposits, loans, investments, insurance, financial planning, trusts, asset management, credit cards and treasury management services.

### Review of 2005

2005 was one of the best years in our history for retail/commercial banking in Tennessee. As the only major bank headquartered in the state, we continued to lead other banks in market share. Our deposit balances and commercial loans grew nearly twice as fast as the market in general. We continued to leverage that successful Tennessee model into our national expansion as we built our banking presence in northern Virginia, Georgia and Texas, expanded our construction lending efforts and successfully cross-sold banking products to our national mortgage customers.

## Capital Markets



Our capital markets segment, operating under the brand FTN Financial, is a full-service provider of financial products for the investment and banking communities.

Products and services include fixed income securities sales and trading, investment banking, equity research and portfolio advisory, among others.

Our fixed income business is one of the nation's top underwriters of U.S. government agency securities.

Our equity research firm, FTN Midwest Securities Corp., is recognized by Institutional Investor as one of the best boutique research firms.

### Review of 2005

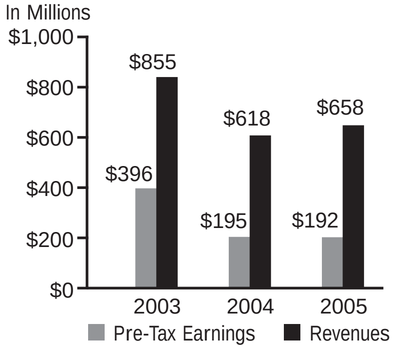
Our operating performance in 2005 was constrained by the interest rate environment that created challenging market conditions for our fixed income business. This business is historically characterized by fairly regular market cycles. While we continued to be impacted in 2005 by the down cycle that began in mid-2004, our capital markets business has produced long-term compounded non-interest income growth rates of 14 percent over the past 20 years. The decline in fixed income revenues in 2005 was partially offset by growth in other products and services, which produced revenues that were 10 percent higher in 2005 than they were in 2004.

## Mortgage Banking

Our First Horizon Home Loans mortgage business is one of the nation's top 20 originators and top 15 mortgage servicers, offering a variety of residential and commercial lending products. We earned a top-10 ranking in customer satisfaction from J.D. Power and Associates.

We also offer appraisals, inspections, flood insurance, property tax payment services and credit report scoring services.

Our home loan offices provide a platform for retail/commercial banking expansion by enabling our employees to build relationships with mortgage customers and then cross-sell these customers numerous other financial products.



### Review of 2005

Mortgage banking was challenged in 2005 by difficult interest rate and yield curve environments. In spite of that, in 2005 our home purchase originations grew 13 percent faster than the national market, largely a result of the 9 percent increase in our number of sales professionals. At the same time, we continued to reduce our servicing cost per loan.

As mortgage banking continued to expand its sales force and improve its servicing portfolio profitability, our mortgage employees continued to offer their first-lien mortgage customers other products, including home equity lines of credit, second-lien mortgages and a variety of deposit products. Now 38 percent of mortgage customers own more than one First Horizon product.

# Corporate Officers

**J. Kenneth Glass**
Chairman of the Board
President and Chief
Executive Officer

**Gerald L. Baker**
Chief Operating Officer

**Charles G. Burkett**
President
Tennessee and National Banking

**Herbert H. Hilliard**
Executive Vice President
Risk Management

**Jim L. Hughes**
President
FTN Financial

**Harry A. Johnson III**
Executive Vice President
General Counsel

**James F. Keen**
Executive Vice President
Corporate Controller

**Peter F. Makowiecki**
President
Mortgage Banking

**Larry B. Martin**
Chief Operating Officer
First Tennessee Financial Services

**Sarah L. Meyerrose**
Executive Vice President
Operations and Technology

**Marty Mosby**
Executive Vice President
Chief Financial Officer

**John P. O'Connor Jr.**
Executive Vice President
Chief Credit Officer

**Elbert L. Thomas Jr.**
Executive Vice President
Interest Rate Risk Management

**Milton A. Gutelius Jr.**
Senior Vice President
Corporate Treasurer

**Clyde A. Billings Jr.**
Senior Vice President
Assistant General Counsel
Corporate Secretary

(as of1/18/2006)

# Board of Directors

**Robert C. Blattberg**
Polk Brothers Distinguished
Professor of Retailing
J.L. Kellogg Graduate School
of Management
Northwestern University

**Simon F. Cooper**
President and
Chief Operating Officer
The Ritz-Carlton Hotel
Company LLC

**J. Kenneth Glass**
Chairman of the Board
President and
Chief Executive Officer
First Horizon National Corporation

**James A. Haslam III**
Chief Executive Officer
Pilot Travel Centers LLC

**R. Brad Martin**
Chairman of the Board
Saks Incorporated

**Vicki R. Palmer**
Executive Vice President
Financial Services and
Administration
Coca-Cola Enterprises Inc.

**Michael D. Rose**
Retired Chairman
Gaylord Entertainment Company

**Mary F. Sammons**
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Chief Executive Officer
Rite Aid Corporation

**William B. Sansom**
Chairman of the Board and
Chief Executive Officer
The H.T. Hackney Co.

**Jonathan P. Ward**
Chairman and
Chief Executive Officer
The ServiceMaster Company

**Luke Yancy III**
President and
Chief Executive Officer
Mid-South Minority
Business Council

FIRST HORIZON
NATIONAL CORPORATION

# FINANCIAL INFORMATION AND DISCUSSION

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# SELECTED FINANCIAL AND OPERATING DATA

| *(Dollars in millions except per share data)* | **2005** | 2004 | 2003 | 2002 | 2001 | 2000 |
|---|---|---|---|---|---|---|
| **Net income before cumulative adjustment*** | **$ 441.1** | $ 454.4 | $ 473.3 | $ 376.5 | $ 326.4 | $ 232.6 |
| **Cumulative effect of changes in accounting principle** | **(3.1)** | - | - | - | (8.2) | - |
| **Net income** | **438.0** | 454.4 | 473.3 | 376.5 | 318.2 | 232.6 |
| **Common Stock Data** | | | | | | |
| Earnings per share before cumulative adjustment* | **$ 3.52** | $ 3.64 | $ 3.73 | $ 2.97 | $ 2.55 | $ 1.79 |
| Earnings per share | **3.49** | 3.64 | 3.73 | 2.97 | 2.49 | 1.79 |
| Diluted earnings per share before cumulative adjustment* | **3.42** | 3.54 | 3.62 | 2.89 | 2.48 | 1.77 |
| Diluted earnings per share | **3.40** | 3.54 | 3.62 | 2.89 | 2.42 | 1.77 |
| Cash dividends declared per share | **1.74** | 1.63 | 1.30 | 1.05 | .91 | .88 |
| Year-end book value per share | **18.18** | 16.39 | 15.01 | 13.35 | 11.66 | 10.70 |
| Closing price of common stock per share: | | | | | | |
| High | **44.55** | 48.01 | 47.98 | 40.45 | 37.25 | 29.06 |
| Low | **35.13** | 41.59 | 36.14 | 30.05 | 27.38 | 16.06 |
| Year-end | **38.44** | 43.11 | 44.10 | 35.94 | 36.26 | 28.94 |
| Dividends per share/year-end closing price | **4.5%** | 3.8% | 2.9% | 2.9% | 2.5% | 3.0% |
| Dividends per share/diluted earnings per share | **51.2** | 46.0 | 35.9 | 36.3 | 36.7 | 49.7 |
| Price/earnings ratio | **11.3x** | 12.2x | 12.2x | 12.4x | 15.0x | 16.3x |
| Market capitalization | **$ 4,888.7** | $ 5,368.0 | $ 5,552.0 | $ 4,553.9 | $ 4,597.0 | $ 3,744.7 |
| Average shares (thousands) | **125,475** | 124,731 | 126,765 | 126,714 | 127,777 | 129,865 |
| Average diluted shares (thousands) | **128,950** | 128,436 | 130,876 | 130,221 | 131,538 | 131,663 |
| Period-end shares outstanding (thousands) | **126,222** | 123,532 | 124,834 | 125,600 | 125,865 | 128,745 |
| Volume of shares traded (thousands) | **162,220** | 173,177 | 176,528 | 139,946 | 110,154 | 99,469 |
| **Selected Average Balances** | | | | | | |
| Total assets | **$36,560.4** | $ 27,305.8 | $25,133.6 | $20,704.0 | $19,227.2 | $19,325.3 |
| Total loans** | **18,294.4** | 15,384.6 | 12,656.3 | 10,634.5 | 10,104.3 | 9,932.0 |
| Investment securities | **2,880.0** | 2,449.1 | 2,544.9 | 2,466.4 | 2,595.3 | 2,862.7 |
| Earning assets | **31,950.0** | 23,718.3 | 21,328.9 | 17,397.4 | 16,125.4 | 16,095.5 |
| Deposits | **23,015.8** | 17,635.5 | 16,111.6 | 13,674.8 | 12,540.6 | 12,932.0 |
| Term borrowings | **2,560.1** | 2,248.0 | 1,342.9 | 685.5 | 521.5 | 384.3 |
| Shareholders' equity | **2,143.4** | 1,905.5 | 1,800.4 | 1,568.3 | 1,401.3 | 1,276.6 |
| **Selected Period-End Balances** | | | | | | |
| Total assets | **$36,579.1** | $ 29,771.7 | $24,506.7 | $23,823.1 | $20,621.6 | $18,559.6 |
| Total loans** | **20,600.9** | 16,427.7 | 13,990.5 | 11,345.4 | 10,283.1 | 10,239.5 |
| Investment securities | **2,912.5** | 2,681.0 | 2,470.4 | 2,700.3 | 2,525.9 | 2,839.0 |
| Earning assets | **31,578.0** | 25,952.3 | 20,621.1 | 19,999.8 | 17,085.7 | 15,193.3 |
| Deposits | **23,437.8** | 19,782.2 | 15,871.3 | 16,126.5 | 13,854.6 | 12,308.0 |
| Term borrowings | **3,437.6** | 2,616.4 | 1,726.8 | 929.7 | 550.4 | 409.7 |
| Shareholders' equity | **2,312.3** | 2,041.0 | 1,890.3 | 1,691.2 | 1,477.8 | 1,384.2 |
| **Selected Ratios** | | | | | | |
| Return on average shareholders' equity before cumulative adjustment* | **20.58%** | 23.85% | 26.29% | 24.00% | 23.29% | 18.22% |
| Return on average shareholders' equity | **20.43** | 23.85 | 26.29 | 24.00 | 22.71 | 18.22 |
| Return on average assets before cumulative adjustment* | **1.21** | 1.66 | 1.88 | 1.82 | 1.70 | 1.20 |
| Return on average assets | **1.20** | 1.66 | 1.88 | 1.82 | 1.66 | 1.20 |
| Net interest margin | **3.08** | 3.62 | 3.78 | 4.35 | 4.29 | 3.75 |
| Allowance for loan losses to loans** | **.92** | .96 | 1.15 | 1.27 | 1.46 | 1.36 |
| Net charge-offs to average loans** | **.21** | .27 | .54 | .93 | .80 | .62 |
| Period-end shareholders' equity to period-end assets | **6.32** | 6.86 | 7.71 | 7.10 | 7.17 | 7.46 |
| Average tangible equity to average tangible assets | **4.87** | 6.24 | 6.37 | 6.70 | 6.66 | 5.98 |

* Cumulative adjustment reflects the effect of changes in accounting principles related to FASB Interpretation No. 47 and derivatives.

** Net of unearned income.

See accompanying notes to consolidated financial statements.

# FIRST HORIZON NATIONAL CORPORATION
# MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

## GENERAL INFORMATION

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

Approximately 13,000 employees provide a broad array of financial services to individual and business customers through hundreds of offices located in 46 states.

FHN companies have been recognized as some of the nation's best employers by AARP, Working Mother and Fortune magazines. 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 our 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, merchant services, check clearing, and correspondent services.

- Mortgage Banking helps provide home ownership through First Horizon Home Loans, which operates offices in 44 states and is one of the top 15 mortgage servicers and top 20 originators of mortgage loans to consumers. This segment consists of core mortgage banking elements including originations and servicing and the associated ancillary revenues related to these businesses.

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

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

For the purpose of this management's discussion and analysis (MD&A), earning assets have been expressed as averages, and loans have been disclosed net of unearned income. The following financial discussion should be read with the accompanying consolidated financial statements and notes. A glossary is included at the end of the MD&A to assist with terminology.

## 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; 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

Earnings for 2005 were $438.0 million, or $3.40 diluted earnings per share, including the cumulative effect of a change in accounting principle. Earnings before the unfavorable cumulative effect ($3.1 million, net of taxes) were $441.1 million or $3.42 diluted earnings per share. Earnings for 2004 were $454.4 million, or $3.54 diluted earnings per share.

- Retail/Commercial Banking pre-tax income increased 21 percent to $475.1 million
- Commercial loans grew 30 percent and retail loans grew 10 percent in 2005
- Retail/Commercial Banking deposits grew 12 percent in 2005 to $10.8 billion
- Capital Markets and Mortgage Banking pre-tax income decreased in 2005 as the continued flattening of the yield curve created pressure on earnings
- Cross-sell penetration of banking products to mortgage customers increased to 38 percent in 2005
- Home-purchase originations grew 25 percent as expansion of the sales force increased market share
- Capital Markets revenues from products other than fixed income grew 10 percent in 2005

Generally, FHN's performance in 2005 was driven by Retail/Commercial Banking which contributed 74 percent of pre-tax income. National expansion continues to favorably impact the bank's performance through successful cross-sell penetration to mortgage customers and expansion of the banking franchise into new markets. Additionally, FHN's leading market position in Tennessee has grown through an expanding sales force, the addition of financial centers in a key metropolitan market and successful marketing to customers of merging banks. The success of these initiatives can be seen through loan growth of 18 percent and deposit growth of 12 percent compared to 2004. Asset quality indicators also remained positive with a net charge-off ratio of 21 basis points compared to 27 basis points in 2004.

Mortgage Banking produced 29 percent of pre-tax income in both 2005 and 2004. Results for 2005 were favorably impacted by a 17 percent increase in mortgage loan originations and a similar increase in the associated revenues. This growth was led by a 25 percent increase in home-purchase originations as expansion of the sales force increased market share. In addition, fees associated with mortgage servicing increased 22 percent as the servicing portfolio grew, and servicing profitability continued to improve as the servicing cost per loan decreased 10 percent. However, continued flattening of the yield curve during 2005 unfavorably impacted Mortgage Banking's results through compression of the spread on the warehouse and unfavorable net hedge results and trading securities valuations.

Capital Markets contributed four percent of pre-tax income in 2005 as it continued to be negatively impacted by the flattening of the yield curve with reduced revenues from fixed income products and compressed spread on securities inventories. However, revenues continued to reflect strong diversification as revenue from fee sources other than fixed income increased 10 percent in 2005, primarily due to increased fees from investment banking and loan sales activities.

The Corporate segment, which absorbs costs associated with supporting the corporate structure, yielded a pre-tax loss of $45.2 million, or a negative seven percent of pre-tax income, in 2005.

2005 results include a charge of $3.1 million, net of taxes, or $0.02 diluted earnings per share, reflecting the cumulative effect of a change in accounting principle related to the adoption of FASB Interpretation No. (FIN) 47, "Accounting for Conditional Asset Retirement Obligations." FIN 47 requires recognition of a liability at the time of acquisition or construction for assets that will require certain remediation expenditures when the assets are removed from service. The adoption of FIN 47 is not expected to have a material effect on earnings in 2006. In addition, the adoption of Staff Accounting Bulletin (SAB) No. 105 in 2004, which prohibited the inclusion of estimated servicing cash flows within the valuation of interest rate lock commitments, lowered pre-tax earnings by $8.4 million in 2004 and diluted earnings per share by $0.04. FHN previously included a portion of the value of the associated servicing cash flows when recognizing loan commitments at inception and throughout their lives. This impact was a one-time accounting change and does not affect the ongoing economic value of this business.

Return on average shareholders' equity and return on average assets for 2005 were 20.4 percent and 1.20 percent, respectively. Excluding the cumulative effect, return on average shareholders' equity and return on average assets were 20.6 percent and 1.21 percent, respectively, compared to 23.9 percent and 1.66 percent in 2004. Total assets were $36.6 billion and shareholders' equity was $2.3 billion on December 31, 2005, compared to $29.8 billion and $2.0 billion, respectively, on December 31, 2004. The increase in total assets resulted from growth in Capital Markets' balance sheet due to the 2005 acquisition of the fixed income business of Spear, Leeds and Kellogg (SLK) and loan growth in Retail/Commercial Banking.

## BUSINESS LINE REVIEW

### Retail/Commercial Banking

Pre-tax income increased 21 percent to $475.1 million in 2005 compared to $392.5 million in 2004. Retail/Commercial Banking contributed 74 percent of total pre-tax income in 2005 compared to 59 percent in 2004. Total revenues increased 16 percent, or $191.9 million, in 2005.

Net interest income increased 24 percent to $859.1 million in 2005 from $694.1 million in 2004. The increase in net interest income is primarily attributable to 18 percent loan growth, with commercial loans growing 30 percent to $8.7 billion from $6.7 billion and retail loans growing 9 percent to $9.5 billion from $8.7 billion. This growth resulted from expansion of the sales force, which increased market share in the core bank, as well as cross-sell opportunities in FHN's national markets with a substantial mortgage presence. Deposit account balances increased 12 percent compared to 2004. Net interest margin in Retail/Commercial Banking was stable in 2005 at 4.28 percent compared to 4.31 percent in 2004.

Noninterest income grew 6 percent, or $26.9 million, led by an increase of $15.7 million in revenue from loan sales and securitizations of home equity lines of credit (HELOC) and second-lien mortgages as FHN continues to utilize securitizations to manage liquidity and fund new loan growth. Partially offsetting this was a negative impact of $14.5 million, which resulted from the write-off of net capitalized expenses on HELOC held for sale as they prepaid faster than anticipated. Merchant processing fees grew 18 percent, or $13.5 million, reflecting increased volume from existing customers as well as an expanded customer base. Fees from deposit services charges increased 5 percent, or $7.7 million, reflecting deposit growth. As FHN continues to divest non-strategic activities, results for 2005 included $7.0 million of divestiture gains from the sale of three financial centers. Similarly, in 2004 divestiture gains of $7.0 million resulted from the sale of certain merchant relationships and an insurance subsidiary.

The provision for loan losses increased to $67.1 million in 2005 from $48.4 million in 2004 as the loan portfolio grew by 18 percent. This increase included $3.8 million in 2005 related to losses in the areas impacted by Hurricanes Katrina and Rita. The net charge-off ratio continued to remain at low levels with 21 basis points in 2005 compared to 27 basis points in 2004, reflecting the stable risk profile of both the commercial and retail loan portfolios.

Noninterest expense was $827.0 million in 2005 compared to $736.4 million in 2004 reflecting higher personnel costs which were largely attributable to national expansion initiatives. The efficiency ratio for retail/commercial banking improved to 60.4 percent in 2005 from 62.6 percent in 2004.

### Mortgage Banking

Pre-tax income was $191.6 million in 2005 compared to $195.2 million in 2004. Mortgage Banking contributed 29 percent of total pre-tax income in 2005 and 2004. Total revenues increased 6 percent, or $39.9 million, in 2005.

Net interest income decreased 4 percent to $146.8 million in 2005 from $153.4 million in 2004. The warehouse grew 19 percent; however, the flattening of the yield curve resulted in compression of the spread on the warehouse. Spread on the warehouse was 2.47 percent in 2005 compared to 3.80 percent for 2004.

Noninterest income increased 10 percent to $511.4 million in 2005 compared to $464.9 million in 2004. 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 mortgage servicing rights (MSR) net hedge gains or losses. Mortgage servicing noninterest income is net of amortization, impairment and other expenses related to MSR and related hedges.

Mortgage loan origination volumes increased 17 percent to $35.7 billion in 2005 from $30.5 billion in 2004, as home purchase-related originations grew 25 percent, or $4.2 billion, and refinance activity grew 7 percent, or $1.0 billion. The increase in home purchase originations demonstrates FHN's success in executing its strategy to grow the purchase market and reflects a sales force of 2,600, which increased by 200, or 9 percent, from 2004. Loans delivered into the secondary market increased 18 percent to $34.6 billion from $29.3 billion. Net revenue from origination activity increased 17 percent to $398.7 million from $339.8 million in 2004.

The mortgage-servicing portfolio (which includes servicing for ourselves and others) grew 10 percent to $95.3 billion on December 31, 2005, from $86.6 billion on December 31, 2004. Total fees associated with mortgage servicing increased 22 percent to $280.2 million from $230.3 million, reflecting growth in the servicing portfolio and the favorable impact of lower prepayment activity. The growth in the servicing portfolio and rising interest rates led to a 26 percent increase in capitalized mortgage servicing rights and a 24 percent, or $36.2 million, increase in amortization expense compared to 2004. In addition, net servicing revenues were unfavorably impacted by a decline in net hedge gains of $41.1 million in 2005 as the continued flattening of the yield curve negatively impacted income from swaps and rising interest rates led to increased option expense.

Noninterest expense increased 10 percent to $466.0 million in 2005 compared to $423.2 million in 2004 due to costs associated with the increased volume of loans delivered into the secondary market. However, as a result of reduced refinancing activity and improvements in processes and technology, productivity improved resulting in a 10 percent reduction of servicing costs per loan compared to year-end 2004.

### Capital Markets

Pre-tax income declined from $88.2 million in 2004 to $23.7 million in 2005 primarily due to a decrease in fixed income revenues and net interest income. Total revenues were $339.3 million in 2005 compared to $389.1 million in 2004.

Net interest income decreased $33.8 million, reflecting a $19.4 million incremental cost of equity charge, largely related to the capital requirements of the SLK acquisition in first quarter 2005, and the compression of the spread on Capital Markets' securities inventory resulting from the flattening of the yield curve.

Revenues from fixed income sales decreased $30.8 million from 2004, while revenues from other fee sources increased $14.8 million. Revenues from other fee sources include fee income from activities such as loan sales, investment banking, equity research, portfolio advisory and the sale of bank-owned life insurance. Revenue from these other sources represented 45 percent of total noninterest income in 2005 compared to 39 percent in 2004 and increased 10 percent to $165.6 million from $150.8 million, primarily due to increased fees from investment banking and loan sales activities.

Noninterest expense increased 5 percent, or $14.7 million, primarily due to amortization and other increased costs resulting from the SLK acquisition and the acquisition of the assets of Alterity Partners, LLC (Alterity) on September 23, 2004.

### Corporate

The Corporate segment's results yielded a pre-tax loss of $45.2 million in 2005 compared to a pre-tax loss of $9.1 million in 2004. Net security losses were $.6 million in 2005 compared to net security gains of $19.8 million in 2004 resulting from the sale of debt securities as the size of the investment portfolio was temporarily reduced to balance an increase in loans held for sale resulting from a delay in the closing of a securitization and from net gains due to the liquidation of a holding company investment. Results in 2005 include $10.8 million in dividend expense on $300 million of noncumulative perpetual preferred stock issued in first quarter 2005.

## INCOME STATEMENT REVIEW – 2005 COMPARED TO 2004

Total revenue increased 7 percent to $2,383.8 million from $2,219.4 million in 2004, including a 15 percent increase in net interest income and a 3 percent increase in noninterest income. A more detailed discussion of the major line items follows.

## NET INTEREST INCOME

Net interest income increased 15 percent to $984.1 million in 2005 from $856.3 million in 2004 as earning assets grew 35 percent to $31.9 billion and interest-bearing liabilities grew 40 percent to $27.4 billion in 2005. See also the Consolidated Average Balance Sheet and Related Yields and Rates table.

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 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. Table 1 details the computation of the net interest margin for FHN for the last three years.

The consolidated net interest margin was 3.08 percent for 2005 compared to 3.62 percent for 2004. This compression in the margin occurred as the net interest spread decreased to 2.64

percent from 3.33 percent in 2004 while earning assets and net interest income increased. The decline in the margin is attributable to two items, the acquisition of SLK and a flatter yield curve. The acquisition of SLK in first quarter 2005 increased the negative pressure on the corporate margin as Capital Markets' balance sheet grew $3.6 billion. In addition, Mortgage Banking negatively impacted the corporate margin in 2005 as the flattening of the yield curve decreased spread on the warehouse by 133 basis points to 2.47 percent.

**Table 1 - Net Interest Margin**

| | **2005** | 2004 | 2003 |
|---|---|---|---|
| **Consolidated yields and rates:** | | | |
| Loans, net of unearned income | **6.20%** | 5.04% | 5.20% |
| Loans held for sale | **6.28** | 5.43 | 5.18 |
| Investment securities | **4.34** | 4.28 | 4.40 |
| Capital markets securities inventory | **4.70** | 3.56 | 3.76 |
| Mortgage banking trading securities | **12.27** | 12.05 | 10.94 |
| Other earning assets | **2.87** | 1.06 | .75 |
| Yields on earning assets | **5.76** | 4.92 | 4.94 |
| Interest-bearing core deposits | **2.03** | 1.39 | 1.38 |
| Certificates of deposit $100,000 and more | **3.34** | 1.57 | 1.34 |
| Federal funds purchased and securities sold under agreements to repurchase | **2.98** | 1.22 | .99 |
| Capital markets trading liabilities | **5.28** | 3.80 | 4.04 |
| Commercial paper and other short-term borrowings | **3.55** | 1.96 | 2.06 |
| Term borrowings | **3.96** | 2.24 | 2.64 |
| Rates paid on interest-bearing liabilities | **3.12** | 1.59 | 1.48 |
| **Net interest spread** | **2.64** | 3.33 | 3.46 |
| Effect of interest-free sources | **.44** | .29 | .32 |
| **FHN – NIM** | **3.08%** | 3.62% | 3.78% |

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

In the near-term, a modest compression of the net interest margin is expected as flattening of the yield curve negatively impacts the spread on the mortgage warehouse. Over the long term, FHN's strategies to manage the interest rate sensitivity of the balance sheet position are designed to allow the net interest margin to improve in a higher interest rate environment. Flattening in the spread between short-term and long-term interest rates generally has an unfavorable impact on net interest margin, primarily from narrower spreads on the mortgage warehouse and capital markets inventories.

Table 2 shows how the changes in yields or rates and average balances compared to the prior year affected net interest income.

**Table 2 - Analysis of Changes in Net Interest Income**

| | 2005 Compared to 2004<br>Increase/(Decrease) Due to* | | | 2004 Compared to 2003<br>Increase/(Decrease) Due to* | | |
|---|---|---|---|---|---|---|
| *(Fully taxable equivalent)*<br>*(Dollars in thousands)* | Rate** | Volume** | Total | Rate** | Volume** | Total |
| **Interest income - FTE:** | | | | | | |
| Loans | **$198,298** | **$160,522** | **$358,820** | $ (22,647) | $139,657 | $117,010 |
| Loans held for sale | **40,180** | **110,870** | **151,050** | 10,240 | (12,500) | (2,260) |
| Investment securities: | | | | | | |
| U.S. Treasury | **391** | **(125)** | **266** | 22 | 54 | 76 |
| U.S. government agencies | **547** | **18,978** | **19,525** | 3,006 | 3,886 | 6,892 |
| States and municipalities | **(135)** | **(333)** | **(468)** | (63) | (739) | (802) |
| Other | **863** | **130** | **993** | (5,230) | (8,084) | (13,314) |
| Total investment securities | **1,888** | **18,428** | **20,316** | (3,164) | (3,984) | (7,148) |
| Capital markets securities inventory | **11,064** | **63,509** | **74,573** | (1,800) | (5,038) | (6,838) |
| Mortgage banking trading securities | **563** | **10,007** | **10,570** | 1,818 | 7,922 | 9,740 |
| Other earning assets: | | | | | | |
| Federal funds sold and securities purchased under agreements to resell | **25,531** | **32,347** | **57,878** | 2,162 | 541 | 2,703 |
| Investment in bank time deposits | **197** | **(5)** | **192** | 5 | 71 | 76 |
| Total other earning assets | **25,810** | **32,260** | **58,070** | 2,178 | 601 | 2,779 |
| Total earning assets/total interest income - FTE | **224,523** | **448,876** | **$673,399** | (7,145) | 120,428 | $113,283 |
| **Interest expense:** | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Savings | **$ 13** | **$ (4)** | **$ 9** | $ (402) | $ (32) | $ (434) |
| Checking interest and money market | **32,162** | **3,296** | **35,458** | 54 | 1,224 | 1,278 |
| Certificates of deposit under $100,000 and other time | **9,261** | **9,692** | **18,953** | 291 | 2,630 | 2,921 |
| Total interest-bearing core deposits | **42,761** | **11,659** | **54,420** | 8 | 3,757 | 3,765 |
| Certificates of deposit $100,000 and more | **168,797** | **87,183** | **255,980** | 12,972 | 25,696 | 38,668 |
| Federal funds purchased and securities sold under agreements to repurchase | **78,305** | **13,201** | **91,506** | 8,445 | (274) | 8,171 |
| Capital markets trading liabilities | **10,401** | **49,773** | **60,174** | (1,327) | (772) | (2,099) |
| Commercial paper and other short-term borrowings | **3,787** | **28,903** | **32,690** | (162) | (283) | (445) |
| Term borrowings | **43,163** | **7,723** | **50,886** | (6,146) | 20,991 | 14,845 |
| Total interest-bearing liabilities/total interest expense | **386,333** | **159,323** | **$545,656** | 18,827 | 44,078 | $ 62,905 |
| Net interest income - FTE | | | **$127,743** | | | $ 50,378 |

* The changes in interest due to both rate and volume have been allocated to change due to rate and change due to volume in proportion to the absolute amounts of the changes in each.

** Variances are computed on a line-by-line basis and are non-additive.

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

## NONINTEREST INCOME

Noninterest income provides the majority of FHN's revenue and contributed 59 percent to total revenue in 2005 compared with 61 percent in 2004. Noninterest income increased $36.6 million led by increases in mortgage banking noninterest income and revenue from loan sales and securitizations. Table 3 provides six years of detailed information concerning FHN's noninterest income. The following discussion provides additional information about various line items reported in the table.

### Table 3 - Noninterest Income

| | | | | | | | Compound Annual Growth Rates (%) | |
|---|---|---|---|---|---|---|---|---|
| *(Dollars in thousands)* | **2005** | 2004 | 2003 | 2002 | 2001 | 2000 | 05/04 | 05/00 |
| **Noninterest income:** | | | | | | | | |
| Mortgage banking | **$ 482,950** | $ 444,758 | $ 649,496 | $ 436,706 | $ 285,032 | $122,454 | 8.6 + | 31.6 + |
| Capital markets | **353,005** | 376,558 | 538,919 | 448,016 | 344,278 | 118,709 | 6.3 - | 24.4 + |
| Deposit transactions and cash management | **156,190** | 148,514 | 146,701 | 143,315 | 133,631 | 116,080 | 5.2 + | 6.1 + |
| Merchant processing | **88,581** | 75,086 | 57,609 | 48,403 | 45,426 | 48,232 | 18.0 + | 12.9 + |
| Insurance commissions | **54,091** | 56,109 | 57,811 | 50,446 | 16,844 | 12,203 | 3.6 - | 34.7 + |
| Revenue from loan sales and securitizations | **47,575** | 23,115 | - | - | - | - | 105.8 + | NM |
| Trust services and investment management | **44,614** | 47,274 | 45,873 | 48,369 | 56,705 | 65,817 | 5.6 - | 7.5 - |
| Gains on divestitures | **7,029** | 7,000 | 22,498 | 4,550 | 80,357 | 157,635 | NM | NM |
| Equity securities (losses)/gains, net | **(579)** | 2,040 | 8,491 | (9,435) | (3,290) | 754 | NM | NM |
| Debt securities gains/(losses), net | **1** | 18,708 | (6,113) | 255 | (1,041) | (4,961) | NM | NM |
| All other income: | | | | | | | | |
| Cardholder fees | **27,381** | 25,075 | 22,698 | 20,145 | 20,137 | 29,666 | 9.2 + | 1.6 - |
| Other service charges | **22,470** | 19,709 | 19,810 | 21,204 | 24,932 | 23,199 | 14.0 + | .6 - |
| Remittance processing | **15,411** | 19,515 | 23,666 | 26,016 | 22,820 | 24,314 | 21.0 - | 8.7 - |
| Check clearing fees | **7,333** | 10,052 | 11,839 | 13,180 | 11,615 | 11,129 | 27.0 - | 8.0 - |
| Other | **93,704** | 89,673 | 68,286 | 60,765 | 57,575 | 71,866 | 4.5 + | 5.5 + |
| Total other income | **166,299** | 164,024 | 146,299 | 141,310 | 137,079 | 160,174 | 1.4 + | .8 + |
| Total noninterest income | **$1,399,756** | $1,363,186 | $1,667,584 | $1,311,935 | $1,095,021 | $797,097 | 2.7 + | 11.9 + |

NM - Due to the variable nature of these items the growth rate is considered to be not meaningful.

### Mortgage Banking

First Horizon Home Loans, an indirect subsidiary of FHN, offers residential mortgage banking products and services to customers, which consist primarily of the origination or purchase of single-family residential mortgage loans. First Horizon Home Loans originates mortgage loans through its retail and wholesale operations and also purchases mortgage loans from third-party mortgage bankers (correspondent brokers) for sale to secondary market investors and subsequently services the majority of those loans. Table 4 provides a summary of First Horizon Home Loans' production/origination of mortgage loans during 2005, 2004 and 2003.

**Table 4 - Production/Origination of Mortgage Loans**

| | **2005** | 2004 | 2003 |
|---|---|---|---|
| Retail channel | **57%** | 57% | 56% |
| Wholesale channel | **38** | 36 | 35 |
| Correspondent brokers | **5** | 7 | 9 |

Origination income includes origination fees, net of costs, gains or losses recognized on loans sold including the capitalized net present value of the 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. Gains or losses from the sale of loans are recognized at the time a mortgage loan is sold into the secondary market. A portion of the gain or loss is recognized at the time an interest rate lock commitment is made to the customer. In second quarter 2004, FHN adopted SAB No. 105, which prohibited the inclusion of estimated servicing cash flows within the valuation of interest rate lock commitments under SFAS No. 133. Previously, FHN included a portion of the value of the associated servicing cash flows when recognizing loan commitments at inception and throughout their lives. The adoption of SAB No. 105, which lowered pre-tax earnings by $8.4 million in 2004, was a one-time change and does not affect the ongoing economic value of this business.

Servicing income includes servicing fees, net gains or losses from hedging MSR, amortization and impairment of MSR, and gains or losses related to fair value adjustments on retained interests classified as mortgage trading securities, primarily interest-only strips, and associated hedges. 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).

Other income includes FHN's share of earnings from nonconsolidated subsidiaries accounted for under the equity method which provide ancillary activities to mortgage banking. As shown in Table 5, total mortgage banking noninterest income increased 9 percent in 2005.

**Table 5 - Mortgage Banking Noninterest Income**

| | | | | Compound Annual Growth Rates (%) | |
|---|---|---|---|---|---|
| *(Dollars in thousands and volume in millions)* | **2005** | 2004 | 2003 | 05/04 | 05/03 |
| **Noninterest income:** | | | | | |
| Origination income | **$ 398,726** | $ 339,845 | $ 602,203 | 17.3 + | 18.6 - |
| Servicing income | **58,188** | 83,796 | 8,186 | 30.6 - | 166.6 + |
| Other | **26,036** | 21,117 | 39,107 | 23.3 + | 18.4 - |
| Total mortgage banking noninterest income | **$ 482,950** | $ 444,758 | $ 649,496 | 8.6 + | 13.8 - |
| Refinance originations - first lien | **$14,778.8** | $ 13,791.5 | $33,810.7 | 7.2 + | 33.9 - |
| Home-purchase originations - first lien | **20,903.1** | 16,673.8 | 13,280.1 | 25.4 + | 25.5 + |
| Mortgage loan originations | **$35,681.9** | $ 30,465.3 | $47,090.8 | 17.1 + | 13.0 - |
| Servicing portfolio | **$95,283.8** | $ 86,586.9 | $68,913.7 | 10.0 + | 17.6 + |

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

Origination income was $398.7 million in 2005 compared to $339.8 million in 2004, primarily reflecting increased origination volume driven by growth in home-purchase originations as an expanded sales force led to market share gains. Loans securitized and sold into the secondary market increased 18 percent to $34.6 billion as origination volume increased.

Servicing income decreased to $58.2 million in 2005 from $83.8 million in 2004. As the servicing portfolio grew 10 percent in 2005, total fees associated with mortgage servicing increased 22 percent or $49.9 million. However, servicing income was unfavorably impacted by a decline in net hedge gains of $41.1 million in 2005 as the continued flattening of the yield curve negatively impacted income from swaps and rising interest rates led to increased option expense. In addition, the increase in size of the servicing portfolio and rising interest rates led to a 26 percent increase in capitalized mortgage servicing rights and a 24 percent, or $36.2 million, increase in amortization expense. However, impairment costs decreased $1.8 million to $35.2 million in 2005 due to the impact that rising interest rates had on the reduced number of loans paying off prematurely.

Other mortgage income increased 23 percent to $26.0 million for 2005 compared with $21.2 million in 2004 primarily due to changes in ancillary activities which include mortgage insurance, flood insurance, credit report, appraisal and tax services.

Going forward, revenue from refinance loan originations will depend on mortgage interest rates. Over time, an increase in rates should reduce origination fees and profit from the sale of loans, but should also reduce MSR impairment losses, while a decrease in rates should increase this net revenue. Home-purchase related originations should reflect the relative strength or weakness of the economy and the growth of the sales force. Actual results could differ because of several factors, including those presented in the Forward-Looking Statements section of the MD&A discussion.

### Capital Markets

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

Capital markets noninterest income decreased to $353.0 million in 2005 from $376.5 million in 2004, as revenues from fixed income sales fell $30.8 million. Revenues from other fee sources represented 43 percent of total noninterest income in 2005 compared to 38 percent in 2004. These revenues increased 5 percent from 2004, primarily due to increased fees from investment banking.

**Table 6 - Capital Markets Noninterest Income**

| | | | | Compound Annual Growth Rates (%) | |
|---|---|---|---|---|---|
| *(Dollars in thousands)* | **2005** | 2004 | 2003 | 05/04 | 05/03 |
| **Noninterest income:** | | | | | |
| Fixed income | **$202,105** | $ 232,917 | $366,488 | 13.2 - | 25.7 - |
| Other products and services | **150,900** | 143,641 | 172,431 | 5.1 + | 6.5 - |
| Total capital markets noninterest income | **$353,005** | $ 376,558 | $538,919 | 6.3 - | 19.1 - |

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

### Deposit Transactions and Cash Management

Deposit transactions include services related to retail deposit products (such as service charges on checking accounts), cash management products and services such as electronic transaction processing (automated clearing house and Electronic Data Interchange), account reconciliation services, cash vault services, lockbox processing, and information reporting to large corporate clients. Noninterest income from deposit transactions and cash management increased to $156.2 million in 2005 from $148.5 million in 2004, reflecting deposit growth.

### Merchant Processing

Merchant processing involves converting transactions from plastic media such as debit cards, credit cards, purchase cards, and private label credit cards into cash for merchants that sell goods and services to consumers and businesses. Fee income from merchant processing increased 18 percent in 2005 to $88.6 million from $75.1 million in 2004, reflecting increased volume from existing customers as well as an expanded customer base.

### Insurance Commissions

Insurance commissions are derived from the sale of insurance products, including acting as an independent agent to provide commercial and personal property and casualty, life, long-term care, and disability insurance. Noninterest income from insurance commissions decreased to $54.1 million in 2005 from $56.1 million in 2004 due to certain small agency divestitures which lowered commissions by $2.9 million in 2005.

### Revenue from Loan Sales and Securitizations

Revenue from loan sales and securitizations includes net gains recognized on HELOC and second-lien mortgage loans sold, including the capitalized net present value of the MSR, servicing fees, amortization and impairment of MSR, and gains or losses related to fair value adjustments on retained interests classified as mortgage trading securities. Noninterest income from loans sales and securitizations increased to $47.6 million in 2005 compared to $23.1 million in 2004 as FHN continues to utilize loan sales and securitizations to manage liquidity and fund new loan growth.

### Trust Services and Investment Management

Trust services and investment management fees include investment management, personal trust, employee benefits, and custodial trust services and are influenced by equity and fixed income market activity. Noninterest income from trust services and investment management was $44.6 million in 2005 compared to $47.3 million in 2004.

### Gains on Divestitures

Gains from divestitures totaled $7.0 million in 2005 and in 2004. FHN continues to divest non-strategic activities, and in 2005 recognized divestiture gains from the sale of three financial centers in a non-strategic Tennessee market. Divestiture gains in 2004 resulted from the sale of certain merchant relationships and an insurance subsidiary. See Note 2 - Acquisitions/Divestitures for additional information.

### Securities Gains/(Losses)

In 2005 there were $.6 million of net securities losses compared to $20.7 million of net securities gains in 2004. Net securities losses for 2005 were primarily due to other-than-temporary impairment of certain equity securities. In 2004, net securities gains included $18.7 million of gains from the sale of investments securities, a gain of $5.5 million from the liquidation of a holding company investment, and a loss of $3.9 million related to other-than-temporary impairment of an investment in Freddie Mac equity securities.

### All Other Income

All other income, which includes cardholder fees, remittance processing income, check clearing fees and other service charges, was $166.3 million in 2005 compared to $164.0 million in 2004.

## NONINTEREST EXPENSE

Total noninterest expense for 2005 increased 11 percent to $1,670.9 million from $1,504.3 million in 2004. Table 8 provides detail by category for the past six years with growth rates.

Employee compensation, incentives and benefits (personnel expense), the largest component of noninterest expense, increased 9 percent to $998.2 million from $915.0 million in 2004 primarily due to national expansion initiatives. Included in personnel expense is the net periodic benefit cost for FHN's pension plan of $8.1 million in 2005, as compared to $7.1 million in 2004. FHN anticipates, based on current conditions, that net periodic benefit cost for the Pension Plan will increase by $3.2 million in 2006 due to normal growth in the qualified pension plan, a decrease in assumed earnings on assets in the qualified plan, and increased costs resulting from a full year of expense related to participants added to the supplemental executive retirement plan during 2005.

All other noninterest expense categories increased 14 percent, or $83.4 million, which included growth in occupancy expense, operations services, dividends on FTBNA perpetual preferred stock, legal and professional fees, contract employment, communications and courier expense, and advertising and public relations. These increases primarily resulted from activity associated with national expansion strategies and other growth initiatives. Additional detail of noninterest expense by business line is provided in Table 7.

**Table 7 - Noninterest Expense Composition**

| *(Dollars in thousands)* | **2005** | 2004 | 2003 |
|---|---|---|---|
| Retail/Commercial Banking | **$ 827,077** | $ 736,388 | $ 717,826 |
| Mortgage Banking | **465,992** | 423,238 | 457,552 |
| Capital Markets | **315,546** | 300,918 | 396,802 |
| Corporate | **62,317** | 43,796 | 95,492 |
| Total noninterest expense | **$1,670,932** | $1,504,340 | $1,667,672 |

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

### Table 8 - Noninterest Expense

| | | | | | | | Compound Annual Growth Rates (%) | |
|---|---|---|---|---|---|---|---|---|
| *(Dollars in thousands)* | **2005** | 2004 | 2003 | 2002 | 2001 | 2000 | 05/04 | 05/00 |
| **Noninterest expense:** | | | | | | | | |
| Employee compensation, incentives and benefits | **$ 998,180** | $ 914,947 | $ 995,609 | $ 830,672 | $ 670,934 | $508,335 | 9.1 + | 14.4 + |
| Occupancy | **106,038** | 89,402 | 83,583 | 76,669 | 69,069 | 80,453 | 18.6 + | 5.7 + |
| Operations services | **79,551** | 67,523 | 67,948 | 60,238 | 59,635 | 70,875 | 17.8 + | 2.3 + |
| Equipment rentals, depreciation and maintenance | **77,117** | 72,695 | 68,973 | 68,736 | 74,106 | 68,230 | 6.1 + | 2.5 + |
| Communications and courier | **56,106** | 49,590 | 50,535 | 45,085 | 42,191 | 41,892 | 13.1 + | 6.0 + |
| Amortization of intangible assets | **13,734** | 9,541 | 7,980 | 6,200 | 10,805 | 11,738 | 43.9 + | 3.2 + |
| All other expense: | | | | | | | | |
| Advertising and public relations | **46,389** | 39,961 | 43,955 | 35,982 | 35,508 | 26,693 | 16.1 + | 11.7 + |
| Legal and professional fees | **45,239** | 37,730 | 60,001 | 37,340 | 32,087 | 26,794 | 19.9 + | 11.0 + |
| Computer software | **32,654** | 28,906 | 28,828 | 26,140 | 25,107 | 19,205 | 13.0 + | 11.2 + |
| Travel and entertainment | **32,126** | 30,794 | 37,432 | 22,501 | 17,489 | 13,891 | 4.3 + | 18.3 + |
| Contract employment | **31,062** | 23,714 | 33,790 | 28,987 | 30,082 | 28,157 | 31.0 + | 2.0 + |
| Supplies | **17,636** | 17,591 | 18,783 | 15,145 | 13,765 | 16,411 | .3 + | 1.5 + |
| Fed service fees | **7,568** | 8,838 | 9,195 | 9,597 | 7,761 | 7,112 | 14.4 - | 1.3 + |
| Foreclosed real estate | **7,265** | 5,834 | 13,137 | 21,479 | 25,452 | 16,080 | 24.5 + | 14.7 - |
| Deposit insurance premium | **3,012** | 3,024 | 2,703 | 2,393 | 2,463 | 2,589 | .4 - | 3.1 + |
| Charitable contributions | **2,203** | 1,497 | 13,370 | 48,337 | 1,745 | 1,188 | 47.2 + | 13.1 + |
| Distributions on guaranteed preferred securities | **-** | - | 8,070 | 8,070 | 8,070 | 8,070 | NM | 100.0 - |
| Distributions on preferred stock of subsidiary | **10,757** | - | 2,282 | 4,564 | 4,535 | 1,178 | NM | 55.6 + |
| Other | **104,295** | 102,753 | 121,498 | 69,171 | 71,348 | 44,636 | 1.5 + | 18.5 + |
| Total other expense | **340,206** | 300,642 | 393,044 | 329,706 | 275,412 | 212,004 | 13.2 + | 9.9 + |
| Total noninterest expense | **$1,670,932** | $1,504,340 | $1,667,672 | $1,417,306 | $1,202,152 | $993,527 | 11.1 + | 11.0 + |

NM - not meaningful

## PROVISION FOR LOAN LOSSES

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 increased 40 percent to $67.7 million in 2005 from $48.3 million in 2004 as the loan portfolio grew $2.9 billion. Included in the provision for 2005 is $3.8 million related to expected hurricane losses.

Going forward the level of provision for loan losses should fluctuate primarily with the strength or weakness of the economies of the markets where FHN does business over the long-run and will experience short-term fluctuations depending on the type and quantity of loan growth and impacts from asset quality movements. Additionally, asset quality in general should remain relatively stable based on expected economic conditions with normal short-term fluctuations; however, asset quality performance during 2005 was relatively strong.

## STATEMENT OF CONDITION REVIEW - 2005 COMPARED TO 2004

Total assets were $36.6 billion on December 31, 2005, compared with $29.8 billion on December 31, 2004. Average assets grew to $36.6 billion in 2005 from $27.3 billion in 2004. Growth in earning assets accounted for 89 percent of the increase in total average assets.

### EARNING ASSETS

Earning assets consist of loans, loans held for sale, investment securities, trading securities and other earning assets. During 2005, earning assets averaged $31.9 billion compared with $23.7 billion for 2004. A more detailed discussion of the major line items follows.

### Loans

Average loans increased 19 percent to $18.3 billion during 2005 as retail loans grew 10 percent and commercial loans grew 30 percent. Average loans were $15.4 billion during 2004. Average loans represented 57 percent of average earning assets in 2005 and 65 percent in 2004. In 2004, FHN transferred approximately $1.6 billion of real estate residential loans to held for sale as a result of management's ongoing evaluation of alternative sources of funding, including securitizations, as loan growth exceeded core deposit growth. Additional loan information is provided in Table 9 and Note 4 - Loans.

**Table 9 - Average Loans**

| *(Dollars in millions)* | **2005** | **Percent of Total** | **2005 Growth Rate** | 2004 | Percent of Total | 2004 Growth Rate | 2003 | Percent of Total |
|---|---|---|---|---|---|---|---|---|
| Commercial: | | | | | | | | |
| Commercial, financial and industrial | **$ 5,979.9** | **33%** | **23.4%** | $ 4,845.6 | 31% | 12.6% | $ 4,304.6 | 34% |
| Real estate commercial | **1,116.4** | **6** | **16.4** | 959.3 | 6 | (9.2) | 1,056.4 | 8 |
| Real estate construction | **1,642.4** | **9** | **83.4** | 895.6 | 6 | 41.5 | 632.9 | 5 |
| Total commercial | **8,738.7** | **48** | **30.4** | 6,700.5 | 43 | 11.8 | 5,993.9 | 47 |
| Retail: | | | | | | | | |
| Real estate residential | **7,661.0** | **42** | **1.7** | 7,533.0 | 49 | 31.8 | 5,716.9 | 45 |
| Real estate construction | **1,488.9** | **8** | **108.4** | 714.6 | 5 | 68.5 | 424.0 | 4 |
| Other retail | **165.0** | **1** | **(11.4)** | 186.3 | 1 | (28.2) | 259.5 | 2 |
| Credit card receivables | **240.8** | **1** | **(3.8)** | 250.2 | 2 | (4.5) | 262.0 | 2 |
| Total retail | **9,555.7** | **52** | **10.0** | 8,684.1 | 57 | 30.3 | 6,662.4 | 53 |
| Total loans, net of unearned | **$ 18,294.4** | **100%** | **18.9%** | $ 15,384.6 | 100% | 21.6% | $ 12,656.3 | 100% |

Commercial loans consist of commercial, financial and industrial; commercial real estate; and commercial construction loans. Commercial, financial and industrial loans continued as the single largest loan category within commercial loans and represented 68 percent of the commercial loan portfolio in 2005 and 72 percent in 2004. Commercial, financial and industrial loans increased 23 percent in 2005, or $1.1 billion, reflecting sales force expansion outside the Tennessee market and increased market share in Tennessee, which includes the effect of recent industry consolidation within the Tennessee market. Commercial construction loans grew 83 percent in 2005, or $746.8 million, primarily from growth in loans to single-family residential builders made through First Horizon Home Loans, reflecting the demand for single-family housing and commercial real estate development and expansion of the sales force and geographic reach. Additional commercial loan information is provided in Table 10.

The retail loan portfolio consists of residential real estate (principally secured by first and/or second liens on residential property), other retail (automobile and other retail installment loans requiring periodic payments of principal and interest), credit card, and retail construction loans.

Residential real estate loans accounted for 80 percent of the retail loan portfolio in 2005 and 87 percent in 2004. The residential real estate loan portfolio averaged $7.7 billion for 2005 compared to $7.5 billion for 2004. The retail real estate construction portfolio increased 108 percent or $774.3 million in 2005. Retail real estate construction loans are a one-time close product where First Horizon Home Loans provides construction financing and a permanent mortgage to individuals for the purpose of constructing a home. Upon completion of construction, the permanent mortgage is classified as held for sale and sold into the secondary market. The increase in these loans reflects the favorable housing environment and expansion of the sales force and geographic reach.

**Table 10 - Contractual Maturities of Commercial Loans on December 31, 2005**

| *(Dollars in thousands)* | Within 1 Year | After 1 Year<br>Within 5 Years | After 5 Years | Total |
|---|---|---|---|---|
| Commercial, financial and industrial | $3,921,567 | $2,239,351 | $417,212 | $6,578,130 |
| Real estate commercial | 371,184 | 682,431 | 159,437 | 1,213,052 |
| Real estate construction | 1,561,911 | 542,852 | 3,358 | 2,108,121 |
| Total commercial loans, net of unearned income | $5,854,662 | $3,464,634 | $580,007 | $9,899,303 |
| For maturities over one year: | | | | |
| Interest rates – floating | | $2,139,351 | $246,614 | $2,385,965 |
| Interest rates – fixed | | 1,325,283 | 333,393 | 1,658,676 |
| Total | | $3,464,634 | $580,007 | $4,044,641 |

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

### Investment Securities

The investment portfolio of FHN consists principally of debt securities used as a source of income, liquidity and collateral for repurchase agreements or public fund deposits. Additionally, the investment portfolio is used as a tool to manage risk from movements in interest rates. The investment portfolio is classified into two categories: securities available for sale (AFS) and securities held to maturity (HTM). Table 11 shows information pertaining to the composition, yields and contractual maturities of the investment securities portfolio.

Investment securities averaged $2.9 billion in 2005 and $2.4 billion in 2004. Investment securities represented 9 percent of earning assets in 2005 and 10 percent in 2004.

On December 31, 2005, AFS securities totaled $2.9 billion and consisted primarily of mortgage-backed securities (MBS), collateralized mortgage obligations (CMO), U.S. Treasury, U.S. government agencies, and equity securities. On December 31, 2005, these securities had $64.6 million of net unrealized losses that resulted in a decrease in book equity of $39.5 million, net of $25.1 million of deferred income taxes. See Note 3 - Investment Securities for additional detail. On December 31, 2004, AFS securities totaled $2.7 billion and had $11.6 million of net unrealized losses that resulted in a decrease in book equity of $7.1 million, net of $4.5 million of deferred income taxes.

### Table 11 - Contractual Maturities of Investment Securities on December 31, 2005 (Amortized Cost)

| | Within 1 Year | | After 1 Year<br>Within 5 Years | | After 5 Years<br>Within 10 Years | | After 10 Years | |
|---|---|---|---|---|---|---|---|---|
| *(Dollars in thousands)* | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield |
| **Securities held to maturity (HTM):** | | | | | | | | |
| States and municipalities* | $ 100 | 9.07% | $ 283 | 8.53% | $ - | -% | $ - | -% |
| Total | $ 100 | 9.07% | $ 283 | 8.53% | $ - | -% | $ - | -% |
| **Securities available for sale (AFS):** | | | | | | | | |
| Government agency issued MBS and CMO** | $ - | -% | $138,337 | 4.36% | $ 38,866 | 5.56% | $2,410,214 | 4.47% |
| U.S. Treasuries | 987 | 4.21 | 39,839 | 4.32 | 364 | 4.28 | - | - |
| Other U.S. government agencies | 6,211 | 3.86 | 53,797 | 4.58 | 76,333 | 4.31 | - | - |
| States and municipalities* | - | - | - | - | - | - | 2,115 | 6.83 |
| Other | 6,481 | 6.36 | 1,640 | 4.93 | 1,088 | 5.26 | 200,422*** | 5.52 |
| Total | $13,679 | 5.07% | $233,613 | 4.41% | $116,651 | 4.74% | $2,612,751 | 4.55% |

* Weighted average yields on tax-exempt obligations have been computed by adjusting allowable tax-exempt income to a fully taxable equivalent basis.

** Represents government agency issued mortgage-backed securities and collateralized mortgage obligations which, when adjusted for early paydowns, have an estimated average life of 3.7 years.

*** Represents equity securities with no stated maturity.

### Loans Held for Sale

Loans held for sale consist of the mortgage warehouse, HELOC, second-lien mortgages, student loans, small issuer trust preferred securities and credit card receivables. The mortgage warehouse accounts for the majority of loans held for sale. Loans held for sale represented 19 percent of total earning assets in 2005 compared with 18 percent in 2004. During 2005 loans held for sale averaged $6.0 billion, an increase of 44 percent, or $1.8 billion from 2004. This growth is related to higher levels of HELOC and second-lien mortgages held for sale and securitization as FHN continues to fund loan growth and maintain a stable liquidity position through loan sales or securitizations. In addition, mortgage warehouse loans increased due to the higher level of originations in 2005. Since mortgage warehouse loans and other loans held for sale are generally held in inventory for a short period of time, there may be significant differences between average and period-end balances. On December 31, 2005, loans held for sale were $4.4 billion, down from $5.2 billion at the end of 2004 principally due to lower levels of HELOC and warehouse loans held for sale. These impacts were partially offset by higher levels of second-lien mortgages and small issuer trust preferred securities in 2005.

### Trading Securities/Other Earning Assets

Trading securities increased 152 percent to $2.5 billion in 2005 from $1.0 billion in 2004. Other earning assets increased 214 percent to $2.3 billion in 2005 from $.7 billion in 2004. These increases were primarily attributable to the acquisition of SLK.

## CORE DEPOSITS

During 2005 core deposits increased 13 percent, or $1.4 billion, and averaged $12.1 billion. Interest-bearing core deposits increased 13 percent or $769.5 million to an average balance of $6.9 billion in 2005. Growth in interest-bearing core deposits is attributable to expansion strategies which emphasize a focus on convenient hours, free checking and targeted financial center expansions. Noninterest-bearing core deposits, which averaged $5.3 billion in 2005, increased 13 percent or $589.8 million primarily due to an increase in corporate deposits, which includes growth in small business customers and larger balances in a cash management product, and an increase in mortgage escrow balances. Going forward, FHN expects to implement strategic growth initiatives including offering financial services, such as deposit-taking, in key markets where FHN already has an established mortgage-banking customer base.

## SHORT-TERM PURCHASED FUNDS/TERM BORROWINGS

Short-term purchased funds (certificates of deposit greater than $100,000, federal funds purchased, securities sold under agreements to repurchase, trading liabilities, commercial paper, and other short-term borrowings), averaged $18.0 billion for 2005, up 60 percent or $6.8 billion from 2004. The increase in short-term purchased funds was used to fund earning asset growth of 35 percent or $8.2 billion in 2005. Short-term purchased funds accounted for 55 percent of FHN's funding (core deposits plus purchased funds and term borrowings) in 2005 and 46 percent in 2004. See Note 9 – Short-Term Borrowings for additional information.

Term borrowings include senior and subordinated borrowings and advances with original maturities greater than one year. Term borrowings increased 14 percent, or $312.1 million, and averaged $2.6 billion in 2005. The increase in term borrowings was also utilized to fund earning asset growth. Term borrowings on December 31, 2005, were $3.4 billion, an increase of 31 percent, or $821.3 million from 2004 year-end. See Note 10 – Term Borrowings for additional information.

## INCOME STATEMENT REVIEW – 2004 COMPARED TO 2003

Earnings in 2004 were $454.4 million, a decrease of 4 percent from $473.3 million earned in 2003. Diluted earnings per common share decreased 2 percent to $3.54 in 2004 from $3.62 in 2003. Return on average assets was 1.66 percent in 2004 compared with 1.88 percent in 2003, and return on average shareholders' equity was 23.9 percent in 2004 compared with 26.3 percent in 2003.

During 2004 net interest income increased 6 percent to $856.3 million from $805.8 million in 2003. Net interest income was positively impacted by growth in the retail and commercial lending portfolios, as loans comprised 65 percent of the earning asset base in 2004 compared to 59 percent in 2003. Some of this positive impact was offset by the divestiture of substantially all of the assets and liabilities of FHN's wholly-owned subsidiary, First National Bank of Springdale (Springdale) on December 31, 2003, which contributed $10.5 million to net interest income in 2003. In addition, the adoption of SFAS No. 150 on July 1, 2003, resulted in FHN classifying its mandatorily redeemable preferred stock of subsidiary to term borrowings which had a negative impact on net interest income in 2004. The December 31, 2003, adoption of FIN 46 which required the deconsolidation of First Tennessee Capital I (see Note 11 – Guaranteed Preferred Beneficial Interests in First Horizon's Junior Subordinated Debentures) also had a negative impact on net interest income in 2004. The combined impact of adopting these two standards on a prospective basis was to increase interest expense by $10.4 million in 2004. An increase in funding costs as noninterest-bearing deposits decreased 9 percent, primarily due to lower escrow balances in mortgage banking, also had a negative impact on net interest income in 2004. The consolidated net interest margin decreased to 3.62 percent for 2004 compared with 3.78 percent for 2003. See Table 1 for a detailed computation of the net interest margin for FHN.

Noninterest income contributed 61 percent to total revenue in 2004 compared to 67 percent in 2003. Mortgage banking noninterest income decreased 32 percent, or $204.7 million, as origination income fell $262.4 million, reflecting a decrease in refinance origination volume and lower margins related to competitive pricing pressures and a change in the relative mix of originations from a higher percentage of fixed rate to a higher percentage of adjustable-rate mortgages. Total servicing income increased $75.6 million due to the positive impact of servicing fee growth combined with a decline in impairment costs of $121.3 million, which resulted from the impact that rising interest rates had on mortgage prepayments in the servicing portfolio. These positive impacts were partially offset by higher amortization costs, which increased $20.4 million, and lower net hedge gains, which fell $67.2 million, reflecting the impacts of interest rate volatility, the flattening of the yield curve and higher costs associated with increased use of option-based hedge instruments. See Table 5 for detail of mortgage banking noninterest income. Capital markets noninterest income decreased to $376.5 million in 2004 from $538.9 million in 2003, primarily due to a reduction in fixed income securities sales. Revenue was favorably impacted in 2003 by higher cash flows from prepayments of mortgage-backed products and agency calls. Merchant processing fees increased 30 percent to $75.1 million from $57.6 million in 2003, as new and existing clients experienced increases in transaction activity. Gains from divestitures totaled $7.0 million in 2004 and $22.5 million in 2003. Divestiture gains in 2004 resulted primarily from the sale of certain merchant relationships. The gains in 2003 reflect FHN's divestiture of Springdale, as well as the sale of certain merchant relationships. In 2004 there were $20.7 million of net securities gains compared to $2.4 million in 2003. Net securities gains for 2004 included $18.7 million of gains from sales of investment securities compared to net losses of $6.1 million in 2003. In 2004 net securities gains from equity investments included a $3.9 million loss related to other-than-temporary impairment of an investment in Freddie Mac equity securities and a $5.5 million gain resulting from the liquidation of a holding company investment. In 2003, net securities gains from equity investments of $8.5 million primarily resulted from the sale of a venture capital investment. All other noninterest income increased 12 percent in 2004, to $164.0 million from $146.3 million.

Total noninterest expense for 2004 decreased 10 percent to $1,504.3 million from $1,667.7 million in 2003. Based on the strong earnings experienced in 2003, noninterest expense included $85.4 million of discretionary spending on performance enhancing initiatives. Personnel expense decreased 8 percent to $915.0 million from $995.6 million in 2003 primarily due to lower activity levels in capital markets in 2004, reflecting lower commissions and incentives. All other expense decreased 12 percent to $589.3 million from $672.1 million in 2003. The declines in advertising, legal and professional fees, charitable contributions, and other expenses were primarily related to discretionary spending reductions in 2004. The decline in travel and entertainment, contract employment and foreclosed real estate were primarily related to the lower activity levels in mortgage banking in 2004. In addition, the adoption of SFAS No. 150 and FIN 46, reduced noninterest expense as it increased interest expense by $10.4 million in 2004.

The provision for loan losses decreased 44 percent to $48.3 million in 2004 from $86.7 million in 2003. The improvement in provision was related to a positive shift in the mix of the loan portfolio and a reduction in specific allocations related to large commercial credits.

## STATEMENT OF CONDITION REVIEW – 2004 COMPARED TO 2003

During 2004, earning assets averaged $23.7 billion compared with $21.3 billion for 2003. Average earning assets were 87 percent of total average assets in 2004, compared with 85 percent in 2003. Average loans increased 22 percent to $15.4 billion during 2004 as retail loans grew 30 percent and commercial loans grew 12 percent. Average loans represented 65 percent of average earning assets in 2004 compared to 59 percent in 2003. In 2004, FHN transferred approximately $1.6 billion of real estate residential loans to available for sale as a result of management's ongoing evaluation of alternative sources of funding, including securitizations, as loan growth exceeded core deposit growth. On December 31, 2003, FHN sold substantially all of the assets and liabilities of Springdale which had average loans of approximately $175 million in 2003.

Commercial, financial and industrial loans increased 13 percent, or $541.0 million, in 2004 as general economic conditions improved. Commercial construction loans grew 42 percent in 2004 or $262.7 million, primarily from growth in loans to single-family residential builders made through First Horizon Home Loans, reflecting the strong demand for single-family housing and expansion of the sales force and geographic reach. Commercial real estate loans decreased 9 percent or $97.1 million primarily due to the divestiture of Springdale. The residential real estate loan portfolio grew 32 percent or $1.8 billion in 2004, primarily due to growth in HELOC. The retail real estate construction portfolio increased 69 percent or $290.6 million in 2004. Retail real estate residential construction loans are a one-time close product where First Horizon Home loans provides construction financing and a permanent mortgage to individuals for the purpose of constructing a home. The increase in these loans reflects the favorable housing environment and expansion of the sales force and geographic reach. Other retail loans decreased 28 percent or $73.2 million in 2004, largely due to a decline in automobile lending.

Investment securities averaged $2.4 billion in 2004 and $2.5 billion in 2003. Investment securities represented 10 percent of earning assets in 2004 and 12 percent in 2003.

Loans held for sale represented 18 percent of total earning assets in 2004 compared with 21 percent in 2003. During 2004 loans held for sale averaged $4.2 billion, a decrease of 5 percent, or $241.3 million, from 2003. At year-end 2004, loans held for sale totaled $5.2 billion compared to $3.0 billion at the end of 2003 due to an increase in HELOC held for sale.

During 2004 core deposits decreased 2 percent, or $185.8 million, and averaged $10.8 billion. This decrease reflects the divestiture of Springdale which had core deposits of approximately $245 million in 2003 and a decline in escrow balances due to lower mortgage refinance originations in 2004. Interest-bearing core deposits increased 4 percent or $254.9 million to an average balance of $6.1 billion in 2004. This growth rate was negatively impacted by the divestiture of Springdale, which had interest-bearing core deposits of approximately $200 million in 2003. Growth in interest-bearing core deposits is attributable to expansion strategies which emphasize a focus on convenient hours, free checking and targeted financial center expansions. Noninterest-bearing core deposits, which averaged $4.7 billion in 2004, decreased 9 percent or $440.6 million primarily due to lower escrow balances in mortgage banking.

Short-term purchased funds averaged $11.2 billion for 2004, up 17 percent or $1.6 billion from the previous year. The increase in short-term purchased funds was used to fund earning asset growth of 11 percent or $2.4 billion in 2004. Term borrowings increased 67 percent or $905.1 million and averaged $2.2 billion in 2004. The increase in term borrowings was also utilized in funding earning asset growth. Term borrowings on December 31, 2004, were $2.6 billion, an increase of 52 percent, or $.9 billion from 2003 year-end.

## CAPITAL

Capital adequacy is an important indicator of financial stability and performance. Management's objectives are to provide capital sufficient to cover the risk inherent in FHN's businesses, to maintain excess capital to well-capitalized standards, and to assure ready access to the capital markets. FHN's capital position remained strong as shown in Table 12. Unrealized market valuations had no material effect on the ratios.

Average shareholders' equity increased 12 percent in 2005 to $2.1 billion from $1.9 billion in 2004, which increased 6 percent from $1.8 billion in 2003. Shareholders' equity was $2.3 billion at year-end 2005, up 13 percent from 2004, which increased 8 percent from year-end 2003. The increase in shareholders' equity during 2005 and 2004 came from retention of net income after dividends and the effects of stock option exercises reduced by shares repurchased. Pursuant to board authority, FHN may repurchase shares from time to time and will evaluate the level of capital and take action designed to generate or use capital, as appropriate, for the interests of the shareholders. In order to maintain FHN's well-capitalized status while sustaining strong balance sheet growth, FHN raised approximately $295 million of additional capital and did not repurchase a significant number of shares in 2005. The Consolidated Statements of Shareholders' Equity highlight the changes in equity since December 31, 2002. See also the Subsequent Events section of this MD&A for additional information.

### Table 12 - Capital Ratios

| | **2005** | 2004 | 2003 |
|---|---|---|---|
| Average shareholders' equity to average assets | **5.86%** | 6.98% | 7.16% |
| Period-end shareholders' equity to assets | **6.32** | 6.86 | 7.71 |
| FHN's tier 1 risk-based capital | **8.55** | 8.62 | 9.22 |
| FHN's total risk-based capital | **12.30** | 13.18 | 13.19 |
| FHN's leverage | **6.67** | 7.16 | 7.19 |

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 December 31, 2005, FHN and FTBNA had sufficient capital to qualify as well-capitalized institutions as shown in Note 13 – Regulatory Capital.

### Table 13 - Issuer Purchases of Equity Securities

| *(Volume in thousands)* | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| **2005** | | | | |
| October 1 to October 31 | - | - | - | 30,010 |
| November 1 to November 30 | - | - | - | 30,010 |
| December 1 to December 31 | - | - | - | 30,010 |
| **Total** | - | - | - | |

Compensation Plan Programs:

– A consolidated compensation plan share purchase program was approved on July 20, 2004, and was announced on August 6, 2004. This plan consolidated into a single share purchase program all of the previously authorized compensation plan share programs as well as the renewal of the authorization to purchase shares for use in connection with two compensation plans for which the share purchase authority had expired. The total amount authorized under this consolidated compensation plan share purchase program is 25.1 million shares which 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.

Other Programs:

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

On December 31, 2005, book value per common share was $18.18 compared to $16.39 for 2004 and $15.01 for 2003. Average shares for the three-year period were 125.5 million in 2005, 124.7 million in 2004 and 126.8 million in 2003. Period-end shares outstanding for this same three-year period were 126.2 million, 123.5 million and 124.8 million, respectively. The decline in shares outstanding in 2004 was primarily related to share repurchases made to offset the impact of the issuance of trust preferred securities and the divestiture of Springdale. FHN's shares are traded on The New York Stock Exchange under the symbol FHN. The sales price ranges, net income per share and dividends declared by quarter, for each of the last two years, are presented in Table 25.

## RISK MANAGEMENT

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

Risk management practices include key elements such as independent checks and balances, formal authority limits, policies and procedures, and portfolio management all executed through experienced personnel. The internal audit department also evaluates risk management activities. These activities include performing internal audits, the results of which are reviewed with management and the Audit Committee, as appropriate.

## INTEREST RATE RISK MANAGEMENT

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

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, net interest income will benefit in a rising interest rate environment and will be negatively impacted in a declining interest rate environment. In the case of floating rate assets and liabilities, FHN may also be exposed to basis risk, which results from changing spreads between loan and deposit rates. Generally, a decline in interest rates increases prepayment risk for MSR.

FHN uses simulation analysis as its primary tool to evaluate interest rate risk exposure. This type of analysis computes net interest income at risk under a variety of market interest rate scenarios to dynamically identify interest rate risk exposures. This simulation, which considers forecasted balance sheet changes, prepayment speeds, deposit mix, pricing impacts, and other changes in the net interest spread, provides an estimate of the annual net interest income at risk for given changes in interest rates. The results help FHN develop strategies for managing exposure to interest rate risk. Like any forecasting technique, interest rate simulation modeling is based on a number of assumptions and judgments. In this case, the assumptions relate primarily to loan and deposit growth, asset and liability prepayments, interest rates, and on- and off-balance sheet management strategies. Management believes the assumptions used in its simulations are reasonable. Nevertheless, simulation modeling provides only a sophisticated estimate, not a precise calculation of exposure to changes in interest rates.

The simulation models used to analyze the retail/commercial bank's net interest income create various at-risk scenarios looking at increases and/or decreases in interest rates from an instantaneous movement or a staggered movement over a certain time period. In addition, the risk of changes in the yield curve is estimated by flattening and steepening the yield curve to historical levels. Management reviews these different scenarios to determine alternative strategies and executes based on that evaluation. The models are continuously updated to incorporate management action. Any scenarios that indicate a net interest income at risk of 3 percent or more are presented to the Board quarterly. A 300 basis point staggered increase or decrease in interest rates over a one-year period is a key scenario analyzed. These hypothetical rate moves are used to simulate net interest income exposure to historically extreme movements in interest rates. The bank's rate sensitivity position shows a risk to scenarios that project declining rates. This position is driven primarily by the impact of increased prepayments on loans and investment securities. Based on the rate sensitivity position on December 31, 2005, net interest income exposure over the next 12 months to a staggered decrease in interest rates of 300 basis points is estimated to be approximately five percent of base net interest income. A staggered increase of 300 basis points results in a favorable variance in net interest income of approximately four percent. A 300 basis point staggered increase and a 300 basis point staggered decrease in interest rates are hypothetical rate scenarios. These scenarios are used as one estimate of risk, and do not necessarily represent management's current view of future interest rates or market developments. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes and changes in market conditions, and management's strategies, among other factors, including those presented in the Forward-Looking Statements section of this MD&A.

Other than the impact related to the immediate change in value of balance sheet accounts, such as MSR, these simulation models and related hedging strategies exclude the dynamics related to how 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 effect of income from originations and sales of loans on total earnings is more significant than servicing related income. Net interest income earned on warehouse loans held for sale and on swaps and similar derivative instruments used to protect the value of MSR increases when the yield curve steepens and decreases when the yield curve flattens. In addition, a flattening yield curve negatively impacts the demand for fixed income securities and, therefore, Capital Markets' revenue, as well as trading inventory spreads.

To determine the amount of interest rate risk and exposure to changes in fair value of loan commitments, warehouse loans and MSR, mortgage banking uses multiple scenario rate shock analysis, including the magnitude and direction of interest rate changes, prepayment speeds, and other factors that could affect mortgage banking. 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 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. Ineffectiveness in these hedging strategies (when changes in the value of the derivative instruments do not match changes in the value of the hedged portion of MSR for any given change in long-term interest rates) is reflected in noninterest income.

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 prepayment risk, due to interest rate changes or other factors, of loans or loans held for sale other than the mortgage warehouse.

Management uses the results of interest rate exposure models to formulate strategies to improve balance sheet positioning, earnings, or both, within FHN's interest rate risk, liquidity and capital guidelines.

Table 14 details FHN's interest rate sensitivity profile on December 31, 2005, based on projected cash flows categorized by anticipated settlement date on capital markets trading securities and expected maturity dates on mortgage banking trading securities. Also provided are the average rates earned on these trading securities. Table 14 also provides both the notional and fair values of derivative financial instruments held for trading. The information provided in this section, including the discussion regarding simulation analysis and rate shock analysis, is forward-looking. Actual results could differ because of interest rate movements, the ability of management to execute its business plans and other factors, including those presented in the Forward-Looking Statements section of this MD&A.

**Table 14 - Risk Sensitivity Analysis**

| ***Held for Trading***<br>*(Dollars in millions)* | 2006 | 2007 | 2008 | 2009 | 2010 | 2011+ | Total | Fair Value |
|---|---|---|---|---|---|---|---|---|
| **Assets:** | | | | | | | | |
| Trading securities | $1,831 | - | - | - | - | $ 302 | $2,133 | $2,133 |
| Average interest rate | 4.84% | - | - | - | - | 11.49% | 5.78% | |
| **Interest Rate Derivatives (notional value):** | | | | | | | | |
| ***Capital Markets:*** | | | | | | | | |
| Forward contracts: | | | | | | | | |
| Commitments to buy | $1,798 | - | - | - | - | - | $1,798 | $ (3) |
| Weighted average settlement price | 99.37% | - | - | - | - | - | 99.37% | |
| Commitments to sell | $2,311 | - | - | - | - | - | $2,311 | $ 3 |
| Weighted average settlement price | 99.25% | - | - | - | - | - | 99.25% | |
| Caps purchased | - | - | $ 10 | - | - | - | $ 10 | * |
| Weighted average strike price | - | - | 4.50% | - | - | - | 4.50% | |
| Caps written | - | - | $ (10) | - | - | - | $ (10) | * |
| Weighted average strike price | - | - | 4.50% | - | - | - | 4.50% | |
| Floors purchased | - | - | - | - | $ 50 | $ 20 | $ 70 | * |
| Weighted average strike price | - | - | - | - | 6.34% | 5.50% | 6.10% | |
| Floors written | - | - | - | - | $ (50) | $ (20) | $ (70) | * |
| Weighted average strike price | - | - | - | - | 6.34% | 5.50% | 6.10% | |
| Swap contracts | $ 8 | $ 29 | $ 29 | - | $ 8 | $ 45 | $ 119 | $ (1) |
| Average pay rate (floating) | 7.21% | 7.32% | 6.64% | - | 6.92% | 4.42% | 6.02% | |
| Average receive rate (fixed) | 6.48% | 6.42% | 4.95% | - | 9.64% | 4.91% | 5.70% | |
| Swap contracts | $ (8) | $ (29) | $ (29) | - | $ (8) | $ (45) | $ (119) | $ 1 |
| Average pay rate (fixed) | 6.48% | 6.42% | 4.95% | - | 9.64% | 4.91% | 5.70% | |
| Average receive rate (floating) | 7.21% | 7.32% | 6.64% | - | 6.92% | 4.42% | 6.02% | |
| Future contracts: | | | | | | | | |
| Commitments to sell | $ 336 | $ 86 | - | - | - | - | $ 422 | * |
| Weighted average settlement price | 97.11% | 95.19% | - | - | - | - | 96.72% | |

* Amount is less than $500,000

## 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. See Note 25 - Derivatives and Off-Balance Sheet Arrangements for additional information. Funds are available from a number of sources, including core deposits, the portfolio of securities available for sale, the Federal Home Loan Bank, the Federal Reserve Banks, access to capital markets through issuance of senior or subordinated bank notes and institutional certificates of deposit, availability to the overnight and term Federal Funds markets, access to retail brokered certificates of deposit, dealer and commercial customer repurchase agreements, and through the sale or securitization of loans.

Core deposits are a significant source of funding and have been a stable source of liquidity for banks. These deposits are insured by the Federal Deposit Insurance Corporation to the extent authorized by law. For 2005, the ratio of average total loans, excluding loans held for sale, to core deposits was 151 percent compared with 143 percent and 116 percent in 2004 and 2003, respectively. As loan growth currently exceeds core deposit growth, alternative sources of funding loan growth may be necessary in order to maintain an adequate liquidity position. One means of maintaining a stable liquidity position is to sell loans either through whole-loan sales or loan securitizations. FHN periodically evaluates its liquidity position in conjunction with determining its ability and intent to hold loans to maturity.

In February 2005, FTBNA established a bank note program providing additional liquidity of $5.0 billion. This bank note program provides a facility under which FTBNA may continuously issue short- and medium-term unsecured notes. On December 31, 2005, $4.3 billion was available under existing conditions through the bank note program as a funding source. Prior to February 2005, FTBNA had a bank note program under which the bank was able to borrow funds from time to time at maturities of 30 days to 30 years. This bank note program has been terminated in connection with the establishment of the new program. That termination does not affect any previously-issued notes outstanding. In November 2005, FTBNA entered into a $3.0 billion floating rate extendible note program. The extendible note program provides FTBNA with a facility under which it may issue and offer unsecured and unsubordinated notes with initial maturities of thirteen months and final maturities of five years. On December 31, 2005, $1.7 billion was available under existing conditions through the extendible note program.

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 300,000 shares of noncumulative perpetual preferred stock which provided approximately $295 million in capital. In addition, liquidity has been obtained through issuance of $300 million of guaranteed preferred beneficial interests in FHN's junior subordinated debentures through two Delaware business trusts, wholly owned by FHN, and through preferred stock issued by an indirect wholly-owned subsidiary of FHN which provided approximately $45 million in capital. See Note 10–Term Borrowings, Note 11–Guaranteed Preferred Beneficial Interests in First Horizon's Junior Subordinated Debentures and Note 12–Preferred Stock of Subsidiary for additional information.

The Consolidated Statements of Cash Flows provide information on cash flows from operating, investing and financing activities for each of the three years ended December 31, 2005. Net cash provided by financing activities was the primary contributor to an increase in cash and cash equivalents for both 2005 and 2004, mainly resulting from growth in deposits and term borrowings. Strong deposit growth provided a significant portion of FHN's positive cash flows from financing activities and was utilized to meet increased liquidity needs related to strong loan growth as reflected in negative cash flows from investing activities during both periods. The issuance of term borrowings is an essential source of cash flows, and term borrowings were also utilized to better match the increased liquidity needs related to strong loan growth during both 2005 and 2004. In 2004, cash flows from operating activities were negative primarily due to funding increased levels of HELOC held for sale and growth in MSR and other retained interests resulting from securitization activities. In 2003, positive cash flows from operating activities as the mortgage warehouse decreased in a rising mortgage interest rate environment provided liquidity to fund growth in the loan portfolio. Earnings represent a significant source of liquidity, consistently providing positive cash flows in each of the three years. Sales and maturities of investment securities largely offset purchases in each of the three years.

Parent company liquidity is maintained by cash flows stemming from dividends and interest payments collected from subsidiaries, which represent the primary source of funds to pay dividends to shareholders and interest to debt holders. The amount of dividends from FTBNA is subject to certain regulatory restrictions that are described in Note 18–Restrictions, Contingencies and Other Disclosures. The parent company statements are presented in Note 26–Parent Company Financial Information. The parent company also has the ability to enhance its liquidity position by raising equity or incurring debt. Under an effective shelf registration statement on file with the SEC, FHN, as of December 31, 2005, may offer, from time to time, at its discretion, debt securities and common and preferred stock aggregating up to $125 million. In addition, $50 million of borrowings under unsecured lines of credit from non-affiliated banks were available to the parent company to provide for general liquidity needs.

### Off-balance Sheet Arrangements and Other Contractual Obligations

First Horizon Home Loans originates conventional conforming and federally insured single-family residential mortgage loans. Likewise, FTN Financial Capital Assets Corporation purchases the same types of loans from customers. Substantially all of these mortgage loans are exchanged for securities, which are issued through investors, such as GNMA for federally insured loans and FNMA and FHLMC for conventional loans, and then sold in the secondary markets. Each of the investors 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 Statements of Condition. See also Note 18–Restrictions, Contingencies and Other Disclosures.

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 2005 and 2004, approximately $16.6 billion and $19.3 billion, respectively, 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 Statements of Condition, except as described hereafter (see Credit Risk Management–Mortgage Banking). These transactions, which are conducted through single-purpose business trusts, are the most efficient way for FHN and other participants in the housing industry to monetize these assets. On December 31, 2005 and 2004, the outstanding principal amount of loans in these off-balance sheet business trusts was $20.0 billion and $11.3 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. See Note 24–Securitizations for additional information.

Pension obligations are funded by FHN to provide current and future benefit to participants in FHN's noncontributory, defined benefit pension plan. On September 30, 2005, the annual measurement date, pension obligations were $379.8 million with $401.9 million of assets in the trust to fund those obligations. All qualified plans are generally funded to the amounts of accumulated benefit obligations. FHN expects to contribute the maximum tax deductible contribution to the pension plan in 2006, which is estimated to be approximately $20 million. In 2005, FHN contributed $37.7 million to the pension plan. The discount rate for 2005 of 5.87 percent was determined by using a hypothetical AA yield curve represented by a series of annualized individual discount rates from one-half to thirty years. The discount rate for the pension plan is selected based on data specific to FHN's plans and employee population. See Note 20–Savings, Pension and Other Employee Benefits for additional information.

FHN has various other financial obligations, which may require future cash payments. Table 15 sets forth contractual obligations representing required and potential cash outflows as of December 31, 2005. 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. See Note 25–Derivatives and Off-Balance Sheet Arrangements for additional information.

**Table 15 - Contractual Obligations**

| | Payments due by period | | | | |
|---|---|---|---|---|---|
| | Less than | 1-3 | 4-5 | After 5 | |
| *(Dollars in thousands)* | 1 year | years | years | years | Total |
| **Contractual obligations:** | | | | | |
| Time deposit maturities* | $11,937,607 | $ 917,870 | $255,558 | $ 299,606 | $13,410,641 |
| Term borrowings** | 350,338 | 2,007,301 | 458 | 1,109,187 | 3,467,284 |
| Annual rental commitments under noncancelable leases*** | 70,757 | 102,517 | 44,475 | 47,062 | 264,811 |
| Purchase obligations | 99,832 | 79,761 | 8,424 | 8,208 | 196,225 |
| Total contractual obligations | $12,458,534 | $3,107,449 | $308,915 | $1,464,063 | $17,338,961 |

* See Note 8 – Time Deposit Maturities for further details.
** See Note 10 – Term Borrowings for further details.
*** See Note 5 – Premises, Equipment and Leases for further details.

### Credit Ratings

Maintaining adequate credit ratings on debt issues is critical to liquidity because it affects the ability of FHN to attract funds from various sources, such as brokered deposits or wholesale borrowings of which FHN had $10.1 billion and $6.2 billion on December 31, 2005 and 2004, respectively, on a cost-competitive basis (see also Liquidity Management). The various credit ratings are detailed in Table 16. The availability of funds other than core deposits is also dependent upon marketplace perceptions of the financial soundness of FHN, which include such issues as capital levels, asset quality and reputation. The availability of core deposit funding is dependent upon federal deposit insurance, which can be removed only in extraordinary circumstances, but may also be influenced to some extent by the same factors that affect other funding sources.

**Table 16 - Credit Ratings**

| | Standard & Poor's | Moody's | Fitch |
|---|---|---|---|
| **First Horizon National Corporation** | | | |
| Overall credit rating | A-/Stable | A2/Stable | A/Stable/F1 |
| Subordinated debt | BBB+ | A3 | A- |
| Capital securities* | BBB | A3 | A- |
| **First Tennessee Bank National Association** | | | |
| Overall credit rating | A/Stable/A-1 | A1/Stable/P-1 | A/Stable/F1 |
| Non-cumulative perpetual preferred stock | BBB+ | A3 | A- |
| Long-term/short-term deposits | A/A-1 | A1/P-1 | A+/F1 |
| Other long-term/short-term funding** | A/A-1 | A1/P-1 | A/F1 |
| Subordinated debt | A- | A2 | A- |
| **FT Real Estate Securities Company, Inc.** | | | |
| Preferred stock | BBB+ | A3 | |

* Guaranteed preferred beneficial interests in First Horizon's junior subordinated debentures issued through a wholly-owned unconsolidated business trust.

** Other funding includes senior bank notes and extendible notes.

A rating is not a recommendation to buy, sell or hold securities and is subject to revision or withdrawal at any time and should be evaluated independently of any other rating.

## MARKET RISK MANAGEMENT

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

## CAPITAL MANAGEMENT

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

## 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, data security, insurance, compliance, records management, product and system development and reputation risks. Summary reports of the committee's activities and decisions are provided to the Enterprise-wide Risk/Return Management Committee. Significant 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.

## 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 depend on the types of transactions, the structure of those transactions and the parties involved. In general, credit risk is incidental to trading, investing, 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 credit management issues. The committee also recommends credit policies, which are submitted for approval to the Executive Committee of the Board, and approves 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.

FHN has a significant concentration in loans secured by real estate which is geographically diversified nationwide. In 2005, 65 percent of total loans are secured by real estate compared to 66 percent in 2004 (see Table 9). Three lending products have contributed to this level of real estate lending–(1) significant levels of second mortgages identified as HELOC which comprise 28 percent of total loans; (2) commercial construction lending which comprises 9 percent of total loans and includes loans to single-family builders; and (3) retail real estate construction, loans to individual consumers to build a home, which grew 108 percent, or $774.3 million, in 2005 and comprises 8 percent of total loans. FHN's commercial real estate lending is well-diversified by product type and industry. On December 31, 2005, FHN did not have any concentrations of 10 percent or more of total commercial, financial and industrial loans in any single industry.

### *Allowance for Loan Losses and Charge-offs*

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. The allowance for loan losses is increased by the provision for loan losses and recoveries and is decreased by charged-off loans. The adequacy of the allowance for loan losses is analyzed quarterly. The Chief Credit Officer has the responsibility for performing a comprehensive review of the allowance for loan losses and making a recommendation to the Executive Committee of the Board for approval of the allowance for loan losses at each quarterly reporting period. An analytical model, based on historical loss experience adjusted for current events, trends and economic conditions, is used to assess the adequacy of the allowance for loan losses. This methodology determines an estimated loss percentage (reserve rate), which is applied against the balance of loans in each segment of the loan portfolio at the evaluation date. The nature of the process by which FHN determines the appropriate allowance for loan losses requires the exercise of considerable judgment. After review of all relevant factors, management believes the allowance for loan losses is adequate and reflects its best estimate of probable incurred losses.

The total allowance for loan losses increased to $189.7 million on December 31, 2005, from $158.2 million at year-end 2004, which was down $2.1 million since year-end 2003. Period-end loans increased 25 percent in 2005 after increasing 17 percent in 2004. The ratio of allowance for loan losses to loans, net of unearned income, was .92 percent on December 31, 2005, compared to .96 percent on December 31, 2004, primarily reflecting the stable risk profile of both the commercial and retail loan portfolios. The ratio of allowance for loan losses to loans was 1.15 percent on December 31, 2003.

Table 18 summarizes by category loans charged-off and recoveries of loans previously charged-off. This table also shows the additions to the reserve through provision. Table 17 shows net charge-off ratios. Net charge-offs decreased to $37.5 million for the year ended December 31, 2005, down from $42.1 million in 2004 and $68.0 million in 2003. The decrease in the 2005 level of net charge-offs was impacted by improvement in both the retail and commercial loan portfolios. Total commercial loan net charge-offs were $11.6 million in 2005 compared to $11.9 million in 2004. The commercial loan net charge-offs, which were not concentrated in any one industry or region, decreased as the economy improved. Residential real estate loan net charge-offs decreased to $13.4 million in 2005 from $16.8 million in 2004 as successful cross-sell efforts to mortgage banking customers led to an improvement in the mix of the portfolio as evidenced by an overall increase in credit scores and reduced loan to value ratios. Credit card receivables net charge-offs decreased to $9.7 million from $10.6 million in 2004, and other retail loan net charge-offs decreased to $2.4 million in 2005 from $2.9 million in 2004. The ratio of net charge-offs to average loans decreased to .21 percent for 2005 from .27 percent for 2004 and .54 percent for 2003.

**Table 17 - Net Charge-off Ratios***

| | **2005** | 2004 | 2003 |
|---|---|---|---|
| Commercial | **.13%** | .18% | .34% |
| Retail real estate | **.15** | .20 | .50 |
| Other retail | **1.46** | 1.55 | 1.64 |
| Credit card receivables | **4.03** | 4.25 | 4.65 |
| Total net charge-offs | **.21** | .27 | .54 |

Loans are averages expressed net of unearned income.
* Table 9 provides information on the relative size of each loan portfolio.

Going forward, asset quality indicators should reflect the relative strength of the economy and the 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. Actual results could differ because of several factors, including those presented in the Forward-Looking Statements section of this MD&A discussion.

## Table 18 - Analysis of Allowance for Loan Losses

| *(Dollars in thousands)* | **2005** | 2004 | 2003 | 2002 | 2001 | 2000 |
|---|---|---|---|---|---|---|
| **Allowance for loan losses:** | | | | | | |
| Beginning balance | **$ 158,159** | $ 160,333 | $ 144,298 | $ 150,614 | $ 139,210 | $ 134,979 |
| Provision for loan losses | **67,678** | 48,348 | 86,698 | 92,184 | 93,220 | 67,491 |
| Loans transferred to held for sale | **-** | (8,382) | - | - | - | - |
| Securitizations | **-** | - | - | - | - | (2,173) |
| Acquisitions/(divestitures), net | **1,386** | - | (2,652) | - | (1,337) | - |
| Charge-offs: | | | | | | |
| Commercial: | | | | | | |
| Commercial, financial and industrial | **12,789** | 11,925 | 12,460 | 37,241 | 22,596 | 6,583 |
| Real estate commercial | **498** | 2,690 | 3,067 | 2,966 | 4,156 | 857 |
| Real estate construction | **2,805** | 779 | 7,642 | 3,367 | 968 | 47 |
| Retail: | | | | | | |
| Real estate residential | **18,744** | 21,271 | 35,809 | 36,726 | 30,532 | 17,348 |
| Real estate construction | **374** | - | - | - | - | - |
| Other retail | **6,101** | 7,094 | 9,920 | 19,979 | 20,603 | 20,868 |
| Credit card receivables | **10,839** | 12,870 | 13,538 | 12,862 | 13,369 | 25,485 |
| Total charge-offs | **52,150** | 56,629 | 82,436 | 113,141 | 92,224 | 71,188 |
| Recoveries: | | | | | | |
| Commercial: | | | | | | |
| Commercial, financial and industrial | **3,328** | 3,473 | 2,438 | 2,136 | 1,991 | 2,903 |
| Real estate commercial | **1,173** | 51 | 166 | 41 | 280 | 480 |
| Real estate construction | **-** | 10 | 1 | - | - | - |
| Retail: | | | | | | |
| Real estate residential | **5,300** | 4,517 | 4,820 | 4,693 | 2,788 | 857 |
| Other retail | **3,697** | 4,211 | 5,653 | 6,419 | 4,953 | 3,937 |
| Credit card receivables | **1,134** | 2,227 | 1,347 | 1,352 | 1,733 | 1,924 |
| Total recoveries | **14,632** | 14,489 | 14,425 | 14,641 | 11,745 | 10,101 |
| Net charge-offs | **37,518** | 42,140 | 68,011 | 98,500 | 80,479 | 61,087 |
| Ending balance | **$ 189,705** | $ 158,159 | $ 160,333 | $ 144,298 | $ 150,614 | $ 139,210 |
| Reserve for off-balance sheet commitments | **$ 10,650** | $ 7,904 | $ 7,804 | $ 5,368 | $ 4,759 | $ 4,486 |
| Total of allowance for loan losses and reserve for off-balance sheet commitments | **$ 200,355** | $ 166,063 | $ 168,137 | $ 149,666 | $ 155,373 | $ 143,696 |
| **Loans and commitments:** | | | | | | |
| Period end loans, net of unearned | **$20,600,935** | $16,427,673 | $13,990,525 | $11,345,445 | $10,283,143 | $10,239,450 |
| Insured retail residential and construction loans* | **826,904** | 665,909 | 862,675 | 785,270 | - | - |
| Loans excluding insured loans | **$19,774,031** | $15,761,764 | $13,127,850 | $10,560,175 | $10,283,143 | $10,239,450 |
| Off-balance sheet commitments** | **$ 9,090,618** | $ 6,226,245 | $ 5,464,097 | $ 3,398,534 | $ 2,895,681 | $ 2,069,143 |
| Average loans, net of unearned | **$18,294,410** | $15,384,650 | $12,656,318 | $10,634,530 | $10,104,277 | $ 9,931,955 |
| **Ratios***:** | | | | | | |
| Allowance to loans | **.92%** | .96% | 1.15% | 1.27% | 1.46% | 1.36% |
| Allowance to loans excluding insured loans | **.96** | 1.00 | 1.22 | 1.37 | 1.46 | 1.36 |
| Allowance to net charge-offs | **5.06x** | 3.75x | 2.36x | 1.46x | 1.87x | 2.28x |
| Net charge-offs to average loans | **.21** | .27 | .54 | .93 | .80 | .62 |

* Whole-loan insurance is obtained on certain retail residential and construction loans. Insuring these loans absorbs credit risk and results in lower allowance for loan losses.

** Amount of off-balance sheet commitments for which a reserve has been provided. See Note 25 – Derivatives and Off-Balance Sheet Arrangements for further details on off-balance sheet commitments.

*** Net of unearned income.

## Table 19 - Loans and Foreclosed Real Estate on December 31

| | **2005** | | | | | | 2004 | | |
|---|---|---|---|---|---|---|---|---|---|
| *(Dollars in millions)* | Commercial | Construction and Development | Commercial Real Estate | **Total** | % of Total | Allowance for Loan Losses | Total | % of Total | Allowance for Loan Losses |
| Internal grades: | | | | | | | | | |
| 1 | $ 301 | $ - | $ - | **$ 301** | 2% | $ 1 | $ 269 | 2% | $ 1 |
| 2 | 461 | 2 | 52 | **515** | 3 | 3 | 529 | 3 | 4 |
| 3 | 743 | 24 | 58 | **825** | 4 | 9 | 674 | 4 | 8 |
| 4 | 3,980 | 1,133 | 866 | **5,979** | 29 | 65 | 4,656 | 28 | 56 |
| 5 | 925 | 894 | 216 | **2,035** | 10 | 29 | 1,419 | 9 | 20 |
| 6 | 50 | 30 | 11 | **91** | - | 4 | 74 | 1 | 3 |
| 7 | 46 | 5 | 1 | **52** | - | 5 | 53 | - | 5 |
| 8, 9, 10 (Classifieds) | 52 | 13 | 5 | **70** | - | 10 | 20 | - | 3 |
| | 6,558 | 2,101 | 1,209 | **9,868** | 48 | 126 | 7,694 | 47 | 100 |
| Impaired loans: | | | | | | | | | |
| Contractually past due | 13 | 7 | 3 | **23** | - | 6 | 34 | - | 10 |
| Contractually current | 8 | - | 1 | **9** | - | 3 | 1 | - | - |
| Total commercial and commercial real estate loans | 6,579 | 2,108 | 1,213 | **9,900** | 48 | 135 | 7,729 | 47 | 110 |
| Retail: | | | | | | | | | |
| Real estate residential | | | | **8,357** | 41 | 37 | 7,245 | 44 | 30 |
| Real estate construction | | | | **1,925** | 9 | 4 | 1,036 | 6 | 3 |
| Other retail | | | | **168** | 1 | 4 | 169 | 1 | 5 |
| Credit card receivables | | | | **251** | 1 | 10 | 249 | 2 | 10 |
| Total retail loans | | | | **10,701** | 52 | 55 | 8,699 | 53 | 48 |
| Total loans | | | | **$20,601** | 100% | $190 | $16,428 | 100% | $158 |
| Foreclosed real estate: | | | | | | | | | |
| Commercial | $ 12 | $ - | $ 2 | **$ 14** | | | $ 15 | | |
| Retail | | | | **5** | | | 4 | | |
| Mortgage banking | | | | **8** | | | 9 | | |
| Total foreclosed real estate | | | | **$ 27** | | | $ 28 | | |

Loans are expressed net of unearned income. All amounts in the Allowance for Loan Losses columns have been rounded to the nearest million dollars. All data is based on internal loan classifications.

Definitions of each credit grade are provided below:

Grade 1: Firmly established, stable companies with excellent earnings, liquidity, and capital. Possess many of the same characteristics as Standard & Poor's (S&P) AA rated companies.

Grade 2: Well-established, stable companies with good to very good earnings, liquidity, and capital. Possess many of the same characteristics as S&P A rated companies.

Grade 3: Reasonably well-established, stable companies with above average to good earnings, liquidity, and capital and with consistent, positive trends relative to industry norms.

Grade 4: Reasonably well-established, stable companies with average earnings, liquidity, and capital.

Grade 5: New and established companies with some potential weakness. Capital considered less than average and history of average to below average earnings without consistent positive trends. Overall acceptable credits with minor weaknesses which warrant additional servicing.

Grade 6: Financial condition adversely affected by temporary lack of earnings or liquidity or changes in the operating environment. An action plan is required to rehabilitate the credit or have it refinanced elsewhere.

Grade 7: Significant developing weaknesses or adverse trends in earnings, liquidity, capital, or operating environment. Limited alternate financing is available.

Grade 8: Significantly higher than normal probability that: (1) legal action will be required; (2) liquidation of collateral will be required; (3) there will be a loss; or all three will occur. This grade is believed to be substantially equivalent to the regulators' classification of substandard.

Grade 9: Excessive degree of risk. Financial and management deficiencies are well-defined and make the obligor's ability to repay from anticipated sources under existing terms and conditions uncertain. Collateral shortfall and/or undeterminable collateral values exist. Timing and amount of loss are uncertain. This grade is believed to be substantially equivalent to the regulators' classification of doubtful.

Grade 10: Borrowers are deemed incapable of repayment and debt is deemed uncollectible. Loans should no longer be carried as an active bank asset. This grade is believed to be substantially equivalent to the regulators' classification of loss.

Impaired: A loan for which it is probable that all amounts due, according to the contractual terms of the loan agreement, will not be collected and the loan is placed on non-accrual status. Reserves for impaired loans are based on the value of the collateral or the cash flow of the entity compared to the outstanding balance.

### *Components of the Allowance for Loan Losses*

The allowance for loan losses is composed of the following components: reserves for individually impaired commercial loans, reserves for commercial loans evaluated based on pools of credit graded loans, and reserves for pools of smaller-balance homogeneous retail and commercial loans. Reserves for individually impaired commercial loans are computed in accordance with SFAS No. 114, "Accounting by Creditors for Impairment of a Loan," and are based on either the estimated collateral value less selling costs (if the loan is a collateral dependent loan), or the present value of expected future cash flows discounted at the loan's effective interest rate. Reserves for commercial loans evaluated based on pools of credit graded loans and reserves for pools of smaller-balance homogeneous retail and commercial loans are determined in accordance with SFAS No. 5, "Accounting for Contingencies." The reserve factors applied to these pools are an estimate of probable incurred losses based on management's evaluation of historical losses from loans with similar characteristics, adjusted for current economic factors and trends. Table 19 gives a breakdown of the allowance allocation by major loan types and commercial loan grades on December 31, 2005, compared with December 31, 2004.

To assess the quality of individual commercial loans, all commercial loans are internally assigned a credit grading, ranging from grades 1 to 10. The credit grading system is intended to identify and measure the credit quality of lending relationships by analyzing the migration of loans between grading categories. It is also integral to the estimation methodology utilized in determining the allowance for loan losses since an allowance is established for pools of commercial loans based on the credit grade assigned. The appropriate relationship manager performs the process of classifying commercial loans into the appropriate credit grades initially as a component of the approval of the loan and has responsibility for insuring that the loan is properly graded throughout the life of the loan. The proper loan grade for all commercial loans in excess of $1 million is confirmed by a senior credit officer in the approval process. To determine the most appropriate credit grade for each loan, based on the size of the loan, credit officers examine and consider both financial and non-financial data as discussed in the credit grade definitions disclosed in Table 19. Loan grades are frequently reviewed by commercial loan review to determine if any changes in the circumstances of the loan require a different risk grade.

A reserve rate is established for each loan grade based on a historical three-year moving average of actual charge-offs. The reserve rate is then adjusted for current events, trends, and economic conditions that affect the asset quality of the loan portfolio. Some of the factors considered in making these adjustments include: levels of and trends in delinquencies; classified loans and nonaccrual loans; trends in outstandings and maturities; effects of changes in lending policies and underwriting guidelines; introduction of new loan products with different risk characteristics; experience, ability and depth of lending management and staff; migration trends of loan grades; and charge-off trends that may skew the historical three-year moving average. Finally, the reserve rates for each loan grade are reviewed quarterly to reflect local, regional and national economic trends; concentrations of cyclical industries; and the economic prospects for industry concentrations. To supplement management's process in setting these additional adjustments, an economic model is used that evaluates the correlation between historical charge-offs and a number of state and national economic indicators. Also, all classified loans $1 million and greater are reviewed individually in accordance with SFAS No. 114, and a specific reserve is set based on the exposure (the difference between the outstanding loan amount and either the present value of expected future cash flows or the estimated net realizable value of the collateral) and the probability of loss.

Table 20 shows the reserve rates (percentage of allowance for loan losses to outstanding balances) by loan category. The average reserve rate for all commercial loans was 1.28 percent in 2005 compared to 1.30 percent in 2004, which was down from 1.49 percent in 2003. This decrease was primarily due to improvement in the historical three-year moving average of actual net charge-offs.

**Table 20 - Average Reserve Rates**

| | **2005** | **Loans<br>% of<br>Total** | 2004 | Loans<br>% of<br>Total | 2003 | Loans<br>% of<br>Total | 2002 | Loans<br>% of<br>Total | 2001 | Loans<br>% of<br>Total |
|---|---|---|---|---|---|---|---|---|---|---|
| Commercial, commercial real estate and commercial construction* | **1.28%** | **47.9** | 1.30% | 46.9 | 1.49% | 43.8 | 1.29% | 50.0 | 1.31% | 54.1 |
| Impaired | **28.13** | **.2** | 28.57 | .2 | 29.41 | .2 | 30.61 | .5 | 44.74 | .4 |
| Retail real estate | **.40** | **49.9** | .40 | 50.4 | .56 | 52.5 | .77 | 44.6 | .99 | 38.3 |
| Other retail | **2.38** | **.8** | 2.96 | 1.0 | 2.35 | 1.5 | 1.05 | 2.5 | 1.96 | 4.5 |
| Credit card receivables | **3.98** | **1.2** | 4.02 | 1.5 | 4.76 | 2.0 | 5.13 | 2.4 | 4.63 | 2.7 |

* Excludes impaired loans.

The allowance for loan losses for smaller-balance homogenous loans (retail loans) is determined based on pools of similar loan types that have similar credit risk characteristics, which is consistent with industry practice. FHN manages retail loan credit risk on a portfolio basis. Reserve rates are established for each segment of the retail loan portfolio based on historical loss experience and are adjusted to reflect current events, trends and economic conditions. Some of the factors for making these adjustments include: changes in underwriting guidelines or credit scoring models; trends in consumer payment patterns, delinquencies and personal bankruptcies; changes in the mix of loan products outstanding; experience, ability and depth of lending management and staff; value of underlying collateral; and charge-off trends.

The average reserve rate for retail real estate loans was .40 percent for 2005 and 2004 compared to .56 percent for 2003. The average reserve rate for other retail loans, a diminishing portfolio of loans which represented less than 1 percent of total loans in 2005, decreased to 2.38 percent for 2005 from 2.96 percent for 2004. The average reserve rate for credit card receivables was 3.98 percent for 2005 and was 4.02 percent for 2004 after decreasing from 4.76 percent for 2003 due to the transfer of a portfolio of credit card receivables to held for sale.

### *Nonperforming Assets*

Nonperforming loans consist of impaired, other nonaccrual and restructured loans. These, along with foreclosed real estate and other assets, represent nonperforming assets. Impaired loans are those loans for which it is probable that all amounts due, according to the contractual terms of the loan agreement, will not be collected and for which recognition of interest income has been discontinued. Other nonaccrual loans are residential and other retail loans on which recognition of interest income has been discontinued. Restructured loans generally take the form of an extension of the original repayment period and/or a reduction or deferral of interest or principal because of deterioration in the financial position of the borrower.

Overall, nonperforming assets remained stable, totaling $79.7 million on December 31, 2005, compared to $77.3 million on December 31, 2004. Nonperforming assets in retail/commercial banking were $59.7 million for 2005 compared to $60.3 million for 2004. However, the retail/commercial banking nonperforming assets ratio decreased to .29 percent from .37 percent as loans increased 24 percent. Mortgage banking nonperforming assets were $20.0 million for 2005 compared to $17.0 million for 2004.

Information regarding nonperforming assets and past-due loans is presented in Table 22. Table 21 gives additional information related to changes in nonperforming assets for 2003 through 2005.

## Table 21 - Changes in Nonperforming Assets

| (Dollars in thousands) | 2005 | 2004 | 2003 |
|---|---|---|---|
| Beginning balance | $ 77,338 | $ 76,195 | $ 75,671 |
| Additional nonperforming assets | 79,554 | 77,059 | 115,851 |
| Payments, sales and other dispositions | (67,036) | (61,852) | (92,916) |
| Charge-offs | (10,187) | (14,064) | (22,411) |
| Ending balance | $ 79,669 | $ 77,338 | $ 76,195 |

## Table 22 - Nonperforming Assets on December 31

| (Dollars in thousands) | 2005 | 2004 | 2003 | 2002 | 2001 | 2000 |
|---|---|---|---|---|---|---|
| **Retail/Commercial Banking:** | | | | | | |
| Nonperforming loans* | $ 40,771 | $ 41,102 | $ 43,228 | $ 58,454 | $ 41,671 | $ 41,541 |
| Foreclosed real estate | 18,932 | 19,247 | 14,677 | 8,188 | 9,924 | 3,997 |
| Other assets | - | - | 336 | 33 | 130 | 97 |
| Total Retail/Commercial Banking | 59,703 | 60,349 | 58,241 | 66,675 | 51,725 | 45,635 |
| **Mortgage Banking:** | | | | | | |
| Nonperforming loans | 11,488 | 8,458 | 8,556 | 5,733 | 21,285 | 19,761 |
| Foreclosed real estate | 8,478 | 8,531 | 9,398 | 3,263 | 12,065 | 12,293 |
| Total Mortgage Banking | 19,966 | 16,989 | 17,954 | 8,996 | 33,350 | 32,054 |
| Total nonperforming assets | $ 79,669 | $ 77,338 | $ 76,195 | $ 75,671 | $ 85,075 | $ 77,689 |
| Potential problem assets*** | $187,208 | $ 98,926 | $118,142 | $125,255 | $123,535 | $107,605 |
| Loans 30 to 89 days past due | 97,780 | 69,593 | 88,874 | 100,723 | 117,298 | 105,705 |
| Loans 30 to 89 days past due – guaranteed | 1,108 | 977 | 2,697 | 3,348 | 5,215 | 20,957 |
| Loans 90 days past due | 37,067 | 33,343 | 27,240 | 37,083 | 37,665 | 42,292 |
| Loans 90 days past due – guaranteed | 5,481 | 5,617 | 5,676 | 6,038 | 6,199 | 16,534 |
| Loans held for sale 30 to 89 days past due** | 45,788 | 56,379 | 73,458 | 10,731 | 11,415 | 22,240 |
| Loans held for sale 30 to 89 days past due – guaranteed** | 30,868 | 43,542 | 60,551 | - | - | - |
| Loans held for sale 90 days past due** | 176,591 | 180,617 | 198,955 | - | - | 1,789 |
| Loans held for sale 90 days past due – guaranteed** | 173,357 | 179,792 | 198,955 | - | - | 707 |
| **Ratios:** | | | | | | |
| Allowance to nonperforming loans in the loan portfolio | 465% | 385% | 371% | 247% | 239% | 227% |
| Nonperforming assets to loans, foreclosed real estate and other assets (Retail/Commercial Banking) | .29 | .37 | .42 | .59 | .50 | .45 |
| Nonperforming assets to unpaid principal balance of servicing portfolio (Mortgage Banking) | .02 | .02 | .03 | .02 | .07 | .07 |

* Total impaired loans included in nonperforming loans were $36.6 million, $34.8 million, $34.4 million, $49.3 million, $37.8 million and $41.2 million for the years 2005 through 2000, respectively.

** Prior to 2003 government guaranteed loans repurchased through GNMA's repurchase program were classified as receivables in "Other assets" on the Consolidated Statements of Condition and are not included in past due loan statistics. Guaranteed loans include FHA, VA, student and GNMA loans repurchased through the GNMA repurchase program.

*** Includes past due loans.

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

### *Past Due Loans and Potential Problem Assets*

Past due loans are loans contractually past due 90 days or more as to interest or principal payments, but which have not yet been put on nonaccrual status. Past due loans increased $3.7 million in 2005 to $37.1 million. However, while total past due balances increased, the ratio of past due loans in the loan portfolio to total loans decreased to .18 percent on December 31, 2005 compared to .20 percent on December 31, 2004 as loans increased 25 percent from December 31, 2004. Loans 30 to 89 days past due increased $28.2 million to $97.8 million while the ratio of loans 30 to 89 days past due in the loan portfolio increased to .47 percent of total loans on December 31, 2005 compared to .42 percent on December 31, 2004. This increase follows a period of significant declines in delinquencies and continues to remain below historical levels. Additional historical past due loan information can be found in Table 22.

Potential problem assets in the loan portfolio, which are not included in nonperforming assets, increased to $187.2 million, or .91 percent of total loans, on December 31, 2005, from $98.9 million, or .60 percent of total loans, on December 31, 2004. The increase reflects a return to historical levels of potential problem assets from the low level experienced in 2004. This includes the impact from the identification of certain misrepresentations by customers in a pool of collateralized retail real estate related loans in 2005. The current expectation of losses from potential problem assets has been included in management's analysis for assessing the adequacy of the allowance for loan losses. Potential problem 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.

### *Mortgage Banking*

First Horizon Home Loans originates mortgage loans through its retail and wholesale operations and also purchases mortgage loans from third-party mortgage bankers (known as correspondent brokers) for sale to secondary market investors and subsequently services the majority of those loans. The secondary market for mortgages allows First Horizon Home Loans to sell mortgage loans to investors, including government agencies, such as FNMA, FHLMC and GNMA. Many private investors are also active in the secondary market as issuers and investors. The majority of First Horizon Home Loans' mortgage loans are sold through transactions with government agencies. 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 mortgage loans are subsequently determined not to meet the agreed-upon qualifications or criteria, the purchaser has the right to return those loans to First Horizon Home Loans. 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).

## CRITICAL ACCOUNTING POLICIES

### APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES

FHN's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. The consolidated 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.

### Mortgage Servicing Rights and Other Related Retained Interests

When First Horizon Home Loans 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. In addition, some ancillary income in the form of late fees and float on escrow balances are collected during the normal course of servicing the loans. An amount is capitalized as MSR on the Consolidated Statements of Condition based on the expected present value of the anticipated cash flows received for servicing the loan, net of the estimated costs of servicing the loan. During 2005 and 2004, First Horizon Home Loans capitalized $423.3 million and $438.0 million, respectively, of MSR in connection with sales of first-lien mortgage loans in the secondary market and acquisition of servicing rights from third parties. On December 31, 2005 and 2004, the total outstanding principal amount of First Horizon Home Loans' first-lien servicing portfolio aggregated $95.3 billion and $86.6 billion, respectively.

### *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, First Horizon Home Loans 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 numerous tranches of MSR, which share similar key characteristics, such as interest rates, type of product (fixed vs. variable), age (new, seasoned, moderate), agency type and other factors.

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 impairment 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.

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

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

Float income: Estimated float income is driven by expected float balances (principal, interest and escrow payments that are held pending remittance to the investor or other third party) and current market interest rates, including the thirty-day London Inter-Bank Offered Rate (LIBOR) and five-year swap interest rates, which are updated on a monthly basis for purposes of estimating the fair value of MSR.

First Horizon Home Loans engages in a process referred to as "price discovery" on a quarterly basis to assess the reasonableness of the estimated fair value of MSR. Price discovery is conducted through a process of obtaining the following information: (a) quarterly informal (and an annual formal) valuation of the servicing portfolio by an independent third party: a prominent mortgage-servicing broker, and (b) a collection of surveys and benchmarking data made available by independent third parties that include peer participants in the mortgage banking business. Although there is no single source of market information that can be relied upon to assess the fair value of MSR, First Horizon Home Loans reviews all information obtained during price discovery to determine whether the estimated fair value of MSR is reasonable when compared to market information. On December 31, 2005, 2004 and 2003, First Horizon Home Loans determined that its MSR valuations and assumptions were reasonable based on the price discovery process.

Each month, the First Horizon Risk Management Committee (FHRMC) reviews the overall assessment of the estimated fair value of MSR. The FHRMC is responsible for approving the critical assumptions used by management to determine the estimated fair value of First Horizon Home Loans' MSR. Each quarter, FHN's MSR Committee reviews the original valuation, impairment, and the initial capitalization rates for newly originated MSR. In addition, each quarter the Executive Committee of FHN's board of directors reviews the initial capitalization rates and approves the amortization expense.

MSR are included on the Consolidated Statements of Condition, net of accumulated amortization. The changes in fair value of MSR are included as a component of mortgage banking noninterest income on the Consolidated Statements of Income.

***Hedging the Fair Value of MSR Under SFAS No. 133***

First Horizon Home Loans also 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 due solely to changes in the benchmark interest rate (10-year LIBOR swap rate). Substantially all capitalized MSR are hedged for economic purposes with the vast majority of MSR routinely qualifying for hedge accounting. For purposes of measuring effectiveness of the hedge, time decay and recognized net interest income, including changes in value attributable to changes in spot and forward prices, if applicable, are excluded from the change in value of the related derivatives. Interest rate derivative contracts used to hedge against interest rate risk in the servicing portfolio are designated to specific risk tranches of servicing. First Horizon Home Loans enters into hedges of the MSR to minimize the effects of loss in value of MSR associated with increased prepayment activity that generally results from declining interest rates. In a rising interest rate environment, the value of the MSR generally will increase while the value of the hedge instruments will decline. Hedges are reset at least monthly and more frequently, as needed, to respond to changes in interest rates or hedge composition. Generally, a coverage ratio approximating 100 percent is maintained on hedged MSR. Prior to acquiring a new hedge instrument, First Horizon Home Loans performs a prospective evaluation of anticipated hedge effectiveness by reviewing the historical regression between the underlying index of the proposed hedge instrument and the mortgage rate. At the end of each hedge period, the change in the fair value of the hedged MSR asset due to the change in benchmark interest rate is calculated and becomes a historical data point. Retrospective hedge effectiveness is determined by performing a regression analysis of all collected data points over a rolling 12-month period.

MSR subject to SFAS No. 133 hedges totaled $1.3 billion and $1.0 billion on December 31, 2005 and 2004, respectively. The balance sheet impacts of the related derivatives were a net liability of $21.2 million and a net asset of $79.0 million on December 31, 2005 and 2004, respectively. Included as a component of net servicing income in mortgage banking noninterest income were net losses of $1.9 million, net gains of $1.4 million, and net gains of $19.7 million in 2005, 2004 and 2003, respectively, representing fair value hedge ineffectiveness. Pursuant to SFAS No. 133, the basis in MSR that qualify for hedge accounting are adjusted for the impact of hedge performance in net servicing income. Also included in net servicing income were gains of $13.9 million, $46.5 million, and $95.4 million in 2005, 2004, and 2003, respectively, representing derivative gains from net interest income on swaps, net of time decay, which were excluded from the assessment of hedge effectiveness.

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 impairment expense on 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 MSR impairment charges during a period of low interest rates. In a period of increased borrower prepayments, impairment can be significantly offset by a strong replenishment rate and strong net margins on new loan originations. To the extent that First Horizon Home Loans is unable to maintain a strong replenishment rate, or in the event that the net margin on new loan originations declines from historical experience, the value of the natural hedge may diminish, thereby significantly impacting the results of operations in a period of increased borrower prepayments.

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

### *Actual vs. Estimated Prepayment Assumptions*

As discussed above, the estimate of the cash flow components of net servicing income associated with MSR requires management to make several critical assumptions based upon current market and loan production data, including prepayment speeds, discount rate, cost to service and float income. Inherent in estimating such assumptions are uncertainties associated with the mortgage banking business (primarily, the change in market interest rates which vary significantly due to multiple economic and non-economic factors) as well as the composition of the MSR portfolio, which is not static and changes significantly based upon the production and sale of new loans, customer prepayment experience and other factors. As a result, the estimated assumptions used to value MSR - particularly the estimate of prepayment speeds – can vary significantly from actual experience, resulting in the recognition of additional impairment charges in current earnings. Table 23 provides a summary of actual and estimated weighted average prepayment speeds used in determining the estimated fair value of MSR for the years ended December 31, 2005, 2004 and 2003.

Each month the actual cash flows of the last 12 months from the total servicing portfolio are compared with the expected cash flow assumptions. Although actual cash flows of individual components differ from expected cash flows, the difference for overall cash flows from the entire servicing portfolio for each of the 12-month periods ending December 31, 2005, 2004 and 2003 was negligible.

For 2005, 2004 and 2003, the amortization rates calculated by the model were 17.1 percent, 17.3 percent and 22.7 percent, respectively, while the related actual runoff was 24.8 percent, 27.8 percent and 55.3 percent, respectively. While actual runoff rates tend to lag interest rate changes, impairment expense generally has an immediate response to changes in the prevailing interest rate environment as FHN's valuation model incorporates all current market drivers when generating future cash flow estimates. To the extent such changes in future cash flows are not completely hedged using derivative instruments, impairment expense can vary accordingly. During 2005, 2004 and 2003, impairment charges associated with MSR of $35.2 million, $37.1 million and $158.3 million, respectively, were recognized.

**Table 23 - Mortgage Banking Prepayment Assumptions**

| | **2005** | 2004 | 2003 |
|---|---|---|---|
| Prepayment speeds | | | |
| Actual | **24.8%** | 27.8% | 55.3% |
| Estimated* | **22.4** | 23.8 | 67.0 |

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

### *Interest-Only Certificates 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 interest-only certificates. Interest-only certificates are financial assets, which represent rights to receive earnings from serviced assets that exceed contractually specified servicing fees. Consistent with MSR, the fair value of an interest-only certificate typically rises as market interest rates increase and declines as market interest rates decrease. Additionally, similar to MSR, the market for interest-only certificates is limited, and the precise terms of transactions involving interest-only certificates 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 interest-only certificates.

Estimating the cash flow components and the resultant fair value of the interest-only certificates 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 interest-only securities include prepayment speeds and discount rates, as discussed above. First Horizon Home Loans' interest-only certificates are included as a component of trading securities on the Consolidated Statements of Condition, with realized and unrealized gains and losses included in current earnings as a component of mortgage banking noninterest income on the Consolidated Statements of Income.

### *Hedging the Fair Value of Interest-Only Certificates*

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. Realized and unrealized gains and losses associated with the change in fair value of derivatives used in the economic hedge of interest-only securities are included in current 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.

The extent to which the change in fair value of interest-only securities is offset by the change in fair value of the derivatives used to hedge these instruments 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 interest-only certificates 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 securities 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 Statements of Condition, with realized and unrealized gains and losses included in current earnings as a component of other income on the Consolidated Statements of Income. FHN does not utilize derivatives to hedge against changes in the fair value of residual-interest certificates.

**Pipeline and Warehouse**

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

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

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

Warehouse loans qualifying for SFAS No. 133 hedge accounting treatment totaled $1.4 billion and $.6 billion on December 31, 2005 and 2004, respectively. The balance sheet impacts of the related derivatives were net liabilities of $.5 million and $2.3 million on December 31, 2005 and 2004, respectively. Included as a component of the gain or loss on the sale of loans in mortgage banking noninterest income were net losses of $1.2 million, net losses of $16.6 million, and net gains of $29.9 million in 2005, 2004 and 2003, respectively, representing fair value hedge ineffectiveness.

Pursuant to SFAS No. 133, the basis in loans that qualify for hedge accounting are adjusted for the impact of hedge performance through gain or loss on the sale of loans.

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

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

For the periods ended December 31, 2005 and 2004, 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 $8.3 million on December 31, 2005, and an asset with an estimated fair value of $16.5 million on December 31, 2004.

**Foreclosure Reserves**

As discussed above, First Horizon Home Loans typically originates mortgage loans with the intent to sell those loans to government agencies 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 December 31, 2005 and 2004, $3.2 billion and $3.4 billion, respectively, of mortgage loans were outstanding which were sold under limited recourse arrangements where some portion of the principal is at risk. On December 31, 2005 and 2004, $147.3 million and $186.8 million, respectively, of mortgage loans were outstanding which were sold 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 and full recourse which management believes is sufficient to cover incurred foreclosure losses in the servicing portfolio. 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 December 31, 2005 and 2004, the foreclosure reserve was $16.4 million and $18.5 million, respectively. While the servicing portfolio has grown from $86.6 billion on, December 31, 2004, to $95.3 billion on December 31, 2005, the foreclosure reserve has decreased primarily due to a reduction in the recourse portfolio. Table 24 provides a summary of reserves for foreclosure losses for the years ended December 31, 2005, 2004 and 2003.

**Table 24 - Reserves for Foreclosure Losses**

| *(Dollars in thousands)* | **2005** | 2004 | 2003 |
|---|---|---|---|
| Beginning balance | **$ 18,500** | $ 22,323 | $ 33,033 |
| Provision for foreclosure losses | **8,562** | 3,574 | 10,012 |
| Charge-offs | **(13,224)** | (11,448) | (22,735) |
| Recoveries | **2,534** | 4,051 | 2,013 |
| Ending balance | **$ 16,372** | $ 18,500 | $ 22,323 |

## 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 Executive Committee of FHN's board of directors approves the level of the allowance for loan losses.

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

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

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

While management uses the best information available to establish the allowance for loan losses, future adjustments to the allowance for loan losses and methodology may be necessary if economic or other conditions differ substantially from the assumptions used in making the 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 years ended December 31, 2005, 2004 and 2003.

**Goodwill and Assessment of Impairment**

FHN's policy is to assess goodwill for impairment at the reporting unit level on an annual basis or between annual assessments if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. Accounting standards require management to estimate the fair value of each reporting unit in making the assessment of impairment at least annually. As of October 1, 2005, FHN engaged an independent valuation firm to compute the fair value estimates of each reporting unit as part of its annual impairment assessment. The independent valuation utilized three separate valuation methodologies and applied a weighted average to each methodology in order to determine fair value for each reporting unit. The valuation as of October 1, 2005, indicated no goodwill impairment for any of the reporting units.

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

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

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

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

**Contingent Liabilities**

A liability is contingent if the amount 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. Note 18 – Restrictions, Contingencies and Other Disclosures provides additional information.

## QUARTERLY FINANCIAL INFORMATION

### Table 25 - Summary of Quarterly Financial Information

| (Dollars in millions except per share data) | **2005** | | | | 2004 | | | |
|---|---|---|---|---|---|---|---|---|
| | **Fourth Quarter** | **Third Quarter** | **Second Quarter** | **First Quarter** | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
| **Summary income information:** | | | | | | | | |
| Interest income | **$519.5** | **$497.5** | **$438.4** | **$384.8** | $334.8 | $300.2 | $277.8 | $254.0 |
| Interest expense | **264.6** | **237.3** | **196.8** | **157.4** | 106.4 | 81.9 | 64.2 | 58.0 |
| Provision for loan losses | **16.2** | **22.6** | **15.8** | **13.1** | 11.7 | 10.1 | 12.3 | 14.2 |
| Noninterest income | **343.4** | **369.5** | **343.4** | **343.4** | 313.1 | 327.6 | 352.3 | 370.1 |
| Noninterest expense | **420.8** | **436.2** | **419.1** | **394.8** | 382.7 | 365.6 | 384.0 | 372.0 |
| Income before cumulative adjustment* | **113.0** | **116.2** | **102.7** | **109.2** | 103.1 | 113.6 | 118.4 | 119.3 |
| Cumulative adjustment, net of tax | **(3.1)** | **-** | **-** | **-** | - | - | - | - |
| Net income | **109.9** | **116.2** | **102.7** | **109.2** | 103.1 | 113.6 | 118.4 | 119.3 |
| **Earnings per common share before cumulative adjustment*** | **$ .89** | **$ .92** | **$ .82** | **$ .88** | $ .83 | $ .91 | $ .95 | $ .95 |
| **Earnings per common share** | **.87** | **.92** | **.82** | **.88** | .83 | .91 | .95 | .95 |
| **Diluted earnings per common share before cumulative adjustment*** | **.87** | **.90** | **.80** | **.85** | .81 | .89 | .92 | .92 |
| **Diluted earnings per common share** | **.85** | **.90** | **.80** | **.85** | .81 | .89 | .92 | .92 |
| **Common stock information:** | | | | | | | | |
| Closing price per share: | | | | | | | | |
| High | **$40.02** | **$44.55** | **$43.26** | **$44.28** | $44.23 | $45.72 | $48.01 | $47.91 |
| Low | **35.13** | **36.35** | **38.77** | **40.00** | 41.59 | 42.82 | 43.00 | 42.70 |
| Period-end | **38.44** | **36.35** | **42.20** | **40.79** | 43.11 | 43.36 | 45.47 | 47.70 |
| Dividends declared per share | **.45** | **.43** | **.43** | **.43** | .43 | .40 | .40 | .40 |

* The cumulative adjustment reflects the effects of a change in accounting principle.

## ACCOUNTING CHANGES

In February 2006, the FASB issued SFAS No.155, "Accounting for Certain Hybrid Financial Instruments," which permits fair value remeasurement for any 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. SFAS No. 155 is effective for fiscal years beginning after September 15, 2006. Since FHN accounts for its beneficial interests in securitizations as trading securities, the adoption of SFAS No. 155 is not expected to have a significant impact on the results of operations.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" (SFAS No. 154), which 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, SFAS No. 154's retrospective application requirement will apply. SFAS No. 154 does not alter the accounting requirement for changes in estimates (prospective) and error corrections (restatement). SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123-R), which requires recognition of expense over the requisite service period for awards of share-based compensation to employees. Due to SEC action in April 2005, the mandatory adoption date for SFAS No. 123-R was moved to January 1, 2006 with earlier adoption permitted. As permitted by the original SFAS No. 123, FHN has accounted for its equity awards under the provisions of APB No. 25. Upon adoption of SFAS No. 123-R, the grant date fair value of an award will be used to measure the compensation expense recognized for the award. For unvested awards granted prior to the adoption of SFAS 123-R, the fair values utilized will equal the values used in preparation of the disclosures required under the original SFAS 123. Compensation expense recognized after adoption of SFAS 123-R will incorporate 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. Upon initial adoption of SFAS 123-R, FHN is required to reclassify deferred compensation balances to capital surplus and to make a cumulative effect adjustment for outstanding unvested awards that are not expected to vest due to anticipated forfeiture. As permitted by SFAS No. 123-R, FHN intends to retroactively apply the provisions of SFAS No. 123-R to its prior period financial statements. Given the current structure of FHN's compensation program, utilization of the Black-Scholes model and applying management's current interpretation, the adoption of SFAS No. 123-R is estimated to result in a reduction of 2006 pre-tax income between $15 million and $21 million, which represents approximately $.07 to $.10 per share.

In the first quarter of 2006, the FASB is expected to issue an amendment to SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" that will require servicing rights to be initially measured at fair value. Subsequently, companies will be permitted to elect, on a class-by-class basis, either fair value or amortized cost accounting for their servicing rights. If this standard is issued as expected, adoption as of January 1, 2006, will be permitted if no quarterly financial statements for 2006 have been issued. A cumulative effect of a change in accounting would be required as of the date of adoption for companies electing to use the fair value method rather than the amortized cost method that is currently required. FHN is currently evaluating the impact of electing fair value accounting for its classes of servicing rights and may elect this methodology in 2006 if the final standard is issued when expected.

## SUBSEQUENT EVENTS

On March 1, 2006 FHN sold substantially all the assets of its national merchant processing business conducted primarily through First Horizon Merchant Services, Inc. and Global Card Services, Inc. The sale was to NOVA Information Systems (NOVA), a wholly-owned subsidiary of U.S. Bancorp. As part of the transaction, FHN also entered into an agreement that will offer NOVA's merchant processing services to FHN's current and prospective customers.

This divestiture resulted in a pre-tax gain to FHN of approximately $340 million. In addition, a supplement to the purchase price may be paid to FHN if certain performance goals are achieved during a period following closing. FHN expects to use a portion of the proceeds from the transaction to repurchase shares of its common stock and to invest in earnings enhancements. This divestiture will be accounted for as a discontinued operation, and prior periods will be adjusted to exclude the impact of merchant operations from the results of continuing operations (see also Note 2–Acquisitions/Divestitures for additional information).

On March 1, 2006, FHN entered into an agreement with Goldman Sachs to purchase four million shares of FHN common stock in connection with an accelerated share repurchase program under an existing share repurchase authorization. The initial purchase price of the shares will be $39.43 per share or approximately $158 million excluding transaction costs. The share repurchase was funded with a portion of the proceeds from the merchant processing sale and settled on March 3, 2006. The repurchased shares are subject to a purchase price adjustment that will be based upon the actual volume weighted average price during the repurchase period and certain other provisions. The final settlement is expected to occur in second quarter 2006.

## GLOSSARY OF SELECTED FINANCIAL TERMS

**Allowance for Loan Losses** – Valuation reserve representing the amount considered by management to be adequate to cover estimated probable incurred losses in the loan portfolio.

**Basis Point** – The equivalent of one-hundredth of one percent (0.01). One hundred basis points equals one percent. This unit is generally used to measure movements in interest yields and rates.

**Book Value Per Common Share** – A ratio determined by dividing shareholders' equity at the end of a period by the number of common shares outstanding at the end of that period.

**Commercial Paper** – A short-term unsecured debt obligation of the parent company with maturities typically of 30 days to 270 days.

**Commercial and Standby Letters of Credit** – Commercial letters of credit are issued or confirmed by an entity to ensure the payment of its customers' payables and receivables. Standby letters of credit are issued by an entity to ensure its customers' performance in dealing with others.

**Commitment to Extend Credit** – Agreements to make or acquire a loan or lease as long as agreed-upon terms (e.g., expiration date, covenants, or notice) are met. Generally these commitments have fixed expiration dates or other termination clauses and may require payment of a fee.

**Core Deposits** – Core deposits consist of all interest-bearing and noninterest-bearing deposits, except certificates of deposit over $100,000. They include checking interest deposits, money market deposit accounts, time and other savings, plus demand deposits.

**Derivative Financial Instrument** – A contract or agreement whose value is derived from changes in interest rates, foreign exchange rates, prices of securities or commodities, or financial or commodity indices.

**Diluted Earnings Per Common Share** – Net income, divided by weighted average shares outstanding plus the effect of common stock equivalents that have the potential to be converted into common shares.

**Earning Assets** – Assets that generate interest or dividend income or yield-related fee income, such as loans and investment securities.

**Earnings Per Common Share** – Net income, divided by the weighted average number of common shares.

**Fully Taxable Equivalent (FTE)** – Reflects the rate of tax-exempt income adjusted to a level that would yield the same after-tax income had that income been subject to taxation.

**Interest-Only Strip** – Mortgage security consisting of the interest rate portion of a stripped mortgage backed security.

**Interest Rate Caps and Floors** – Contracts with notional principal amounts that require the seller, in exchange for a fee, to make payments to the purchaser if a specified market interest rate exceeds a fixed upper "capped" level or falls below a fixed lower "floor" level on specified future dates.

**Interest Rate Forward Contracts** – Contracts representing commitments either to purchase or sell at a specified future date a specified security or financial instrument at a specified price, and may be settled in cash or through delivery.

**Interest Rate Option** – A contract that grants the holder (purchaser), for a fee, the right to either purchase or sell a financial instrument at a specified price within a specified period of time or on a specified date from or to the writer (seller) of the option.

## GLOSSARY OF SELECTED FINANCIAL TERMS (continued)

**Interest Rate Swap** – An agreement in which two entities agree to exchange, at specified intervals, interest payment streams calculated on an agreed-upon notional principal amount with at least one stream based on a floating rate index.

**Leverage Ratio** – Ratio consisting of Tier 1 capital divided by quarterly average assets adjusted for certain unrealized gains/(losses) on available for sale securities, goodwill, certain other intangible assets, the disallowable portion of mortgage servicing rights and other disallowed assets.

**Market Capitalization** – Market value of a company computed by multiplying the number of shares outstanding by the current stock price.

**Mortgage Backed Securities** – Investment securities backed by a pool of mortgages or trust deeds. Principal and interest payments on the underlying mortgages are used to pay principal and interest on the securities.

**Mortgage Pipeline** – Interest rate commitments made to customers on mortgage loans that have not yet been closed and funded.

**Mortgage Warehouse** – A mortgage loan that has been closed and funded and is awaiting sale and delivery into the secondary market.

**Mortgage Servicing Rights (MSR)** – The right to service mortgage loans, generally owned by someone else, for a fee. Loan servicing includes collecting payments; remitting funds to investors, insurance companies, and taxing authorities; collecting delinquent payments; and foreclosing on properties when necessary.

**Net Interest Income (NII)** – Interest income less interest expense.

**Net Interest Margin (NIM)** – Expressed as a percentage, net interest margin is a measure of the profitability of earning assets. It is computed by dividing fully taxable equivalent net interest income by average earning assets.

**Net Interest Spread** – The difference between the average yield earned on earning assets on a fully taxable equivalent basis and the average rate paid for interest-bearing liabilities.

**Nonaccrual Loans** – Loans on which interest accruals have been discontinued due to the borrower's financial difficulties. Interest income on these loans is reported on a cash basis as it is collected after recovery of principal.

**Nonperforming Assets** – Interest-earning assets on which interest income is not being accrued, real estate properties acquired through foreclosure and repossessed assets.

**Principal-Only Strip** – Mortgage security consisting of the principal portion of a stripped mortgage backed security.

**Provision for Loan Losses** – The periodic charge to earnings for potential losses in the loan portfolio.

**Purchase Obligation** – An agreement to purchase goods or services that is enforceable and legally binding and that specifies all significant terms, including fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction.

**Purchased Funds** – The combination of certificates of deposit greater than $100,000, federal funds purchased, securities sold under agreement to repurchase, bank notes, commercial paper, and other short-term borrowings.

## GLOSSARY OF SELECTED FINANCIAL TERMS (continued)

**Repurchase Agreement** – A method of short-term financing where one party agrees to buy back, at a future date (generally overnight) and an agreed-upon price, a security it sells to another party.

**Return on Average Assets (ROA)** – A measure of profitability that indicates how effectively an institution utilized its assets. It is calculated by dividing net income by total average assets.

**Return on Average Equity (ROE)** – A measure of profitability that indicates what an institution earned on its shareholders' investment. ROE is calculated by dividing net income by total average shareholders' equity.

**Risk-Adjusted Assets** – A regulatory risk-based calculation that takes into account the broad differences in risks among a banking organization's assets and off-balance sheet financial instruments.

**Tier 1 Capital Ratio** – Ratio consisting of shareholders' equity adjusted for certain unrealized gains/(losses) on available for sale securities, reduced by goodwill, certain other intangible assets, the disallowable portion of mortgage servicing rights and other disallowed assets divided by risk-adjusted assets.

**Total Capital Ratio** – Ratio consisting of Tier 1 capital plus the allowable portion of the allowance for loan losses and qualifying subordinated debt divided by risk-adjusted assets.

# FIRST HORIZON NATIONAL CORPORATION
# REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of First Horizon National Corporation is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. First Horizon National Corporation's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Even effective internal controls, no matter how well designed, have inherent limitations such as the possibility of human error or of circumvention or overriding of controls, and consideration of cost in relation to benefit of a control. Moreover, effectiveness must necessarily be considered according to the existing state of the art of internal control. Further, because of changes in conditions, the effectiveness of internal controls may diminish over time.

Management assessed the effectiveness of First Horizon National Corporation's internal control over financial reporting as of December 31, 2005. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on our assessment and those criteria, management believes that First Horizon National Corporation maintained effective internal control over financial reporting as of December 31, 2005.

First Horizon National Corporation's independent auditors have issued an attestation report on management's assessment of First Horizon National Corporation's internal control over financial reporting. That report appears on the following page.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders
First Horizon National Corporation:

We have audited management's assessment, included in the accompanying *Management's Report on Internal Control Over Financial Reporting*, that First Horizon National Corporation (the Company) maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that First Horizon National Corporation maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by COSO. Also, in our opinion, First Horizon National Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of condition of First Horizon National Corporation as of December 31, 2005 and 2004, and the related consolidated statements of income, shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2005, and our report dated March 3, 2006 expressed an unqualified opinion on those consolidated financial statements.

KPMG LLP

Memphis, Tennessee
March 3, 2006

# REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders
First Horizon National Corporation:

We have audited the accompanying consolidated statements of condition of First Horizon National Corporation (the Company) as of December 31, 2005 and 2004, and the related consolidated statements of income, shareholders' equity and cash flows for each of the years in the three year period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First Horizon National Corporation as of December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of First Horizon National Corporation's internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 3, 2006 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

KPMG LLP

Memphis, Tennessee
March 3, 2006

# CONSOLIDATED STATEMENTS OF CONDITION

| *(Dollars in thousands)* | December 31<br>**2005** | <br>2004 |
|---|---|---|
| **Assets:** | | |
| Cash and due from banks (Note 18) | **$ 946,421** | $ 638,189 |
| Federal funds sold and securities purchased under agreements to resell | **1,485,199** | 682,310 |
| Total cash and cash equivalents | **2,431,620** | 1,320,499 |
| Investment in bank time deposits | **10,687** | 5,329 |
| Trading securities | **2,133,428** | 988,015 |
| Loans held for sale | **4,435,343** | 5,167,981 |
| Securities available for sale (Note 3) | **2,912,103** | 2,680,556 |
| Securities held to maturity (fair value of $390 on December 31, 2005, and $457 on December 31, 2004) (Note 3) | **383** | 441 |
| Loans, net of unearned income (Note 4) | **20,600,935** | 16,427,673 |
| Less: Allowance for loan losses | **189,705** | 158,159 |
| Total net loans | **20,411,230** | 16,269,514 |
| Mortgage servicing rights, net (Note 6) | **1,314,629** | 1,036,458 |
| Goodwill (Note 7) | **308,788** | 187,200 |
| Other intangible assets, net (Note 7) | **85,863** | 34,769 |
| Capital markets receivables | **511,508** | 276,298 |
| Premises and equipment, net (Note 5) | **414,980** | 379,359 |
| Real estate acquired by foreclosure | **27,410** | 27,777 |
| Other assets | **1,581,089** | 1,397,487 |
| **Total assets** | **$36,579,061** | $ 29,771,683 |
| **Liabilities and shareholders' equity:** | | |
| Deposits: | | |
| Checking interest and money market | **$ 4,425,664** | $ 4,220,376 |
| Savings | **279,408** | 289,831 |
| Certificates of deposit under $100,000 and other time | **2,478,946** | 2,061,262 |
| Certificates of deposit $100,000 and more | **10,931,695** | 8,216,176 |
| Interest-bearing | **18,115,713** | 14,787,645 |
| Noninterest-bearing | **5,322,057** | 4,994,522 |
| Total deposits | **23,437,770** | 19,782,167 |
| Federal funds purchased and securities sold under agreements to repurchase (Note 9) | **3,735,742** | 3,247,048 |
| Trading liabilities (Note 9) | **793,638** | 426,343 |
| Commercial paper and other short-term borrowings (Note 9) | **802,017** | 139,776 |
| Term borrowings (Note 10) | **3,437,643** | 2,616,368 |
| Capital markets payables | **591,404** | 390,323 |
| Other liabilities | **1,173,262** | 1,128,217 |
| Total liabilities | **33,971,476** | 27,730,242 |
| Preferred stock of subsidiary (Note 12) | **295,274** | 458 |
| **Shareholders' equity:** | | |
| Preferred stock – no par value (5,000,000 shares authorized, but unissued) | **-** | - |
| Common stock – $.625 par value (shares authorized – 400,000,000; shares issued – 126,222,327 on December 31, 2005 and 123,531,904 on December 31, 2004) | **78,889** | 77,207 |
| Capital surplus | **267,678** | 173,872 |
| Undivided profits | **2,015,982** | 1,795,853 |
| Accumulated other comprehensive loss, net (Note 15) | **(42,244)** | (9,928) |
| Deferred compensation on incentive plans | **(20,111)** | (8,181) |
| Deferred compensation obligation | **12,117** | 12,160 |
| Total shareholders' equity | **2,312,311** | 2,040,983 |
| **Total liabilities and shareholders' equity** | **$36,579,061** | $ 29,771,683 |

See accompanying notes to consolidated financial statements.

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

# CONSOLIDATED STATEMENTS OF INCOME

| | Year Ended December 31 | | |
|---|---|---|---|
| *(Dollars in thousands except per share data)* | **2005** | 2004 | 2003 |
| **Interest income:** | | | |
| Interest and fees on loans | **$1,133,490** | $ 774,688 | $ 657,546 |
| Interest on investment securities | **124,471** | 104,144 | 111,257 |
| Interest on loans held for sale | **377,882** | 226,832 | 229,091 |
| Interest on trading securities | **138,521** | 53,398 | 50,515 |
| Interest on other earning assets | **65,810** | 7,740 | 4,961 |
| Total interest income | **1,840,174** | 1,166,802 | 1,053,370 |
| **Interest expense:** | | | |
| Interest on deposits: | | | |
| Savings | **408** | 399 | 832 |
| Checking interest and money market | **59,475** | 24,017 | 22,739 |
| Certificates of deposit under $100,000 and other time | **79,013** | 60,060 | 57,139 |
| Certificates of deposit $100,000 and more | **363,983** | 108,003 | 69,336 |
| Interest on trading liabilities | **80,191** | 20,017 | 22,116 |
| Interest on short-term borrowings | **171,936** | 47,740 | 40,014 |
| Interest on term borrowings | **101,141** | 50,255 | 35,410 |
| Total interest expense | **856,147** | 310,491 | 247,586 |
| **Net interest income** | **984,027** | 856,311 | 805,784 |
| Provision for loan losses | **67,678** | 48,348 | 86,698 |
| **Net interest income after provision for loan losses** | **916,349** | 807,963 | 719,086 |
| **Noninterest income:** | | | |
| Mortgage banking | **482,950** | 444,758 | 649,496 |
| Capital markets | **353,005** | 376,558 | 538,919 |
| Deposit transactions and cash management | **156,190** | 148,514 | 146,701 |
| Merchant processing | **88,581** | 75,086 | 57,609 |
| Insurance commissions | **54,091** | 56,109 | 57,811 |
| Revenue from loan sales and securitizations | **47,575** | 23,115 | - |
| Trust services and investment management | **44,614** | 47,274 | 45,873 |
| Gains on divestitures | **7,029** | 7,000 | 22,498 |
| Equity securities (losses)/gains, net | **(579)** | 2,040 | 8,491 |
| Debt securities gains/(losses), net | **1** | 18,708 | (6,113) |
| All other income (Note 14) | **166,299** | 164,024 | 146,299 |
| Total noninterest income | **1,399,756** | 1,363,186 | 1,667,584 |
| **Adjusted gross income after provision for loan losses** | **2,316,105** | 2,171,149 | 2,386,670 |
| **Noninterest expense:** | | | |
| Employee compensation, incentives and benefits | **998,180** | 914,947 | 995,609 |
| Occupancy | **106,038** | 89,402 | 83,583 |
| Operations services | **79,551** | 67,523 | 67,948 |
| Equipment rentals, depreciation and maintenance | **77,117** | 72,695 | 68,973 |
| Communications and courier | **56,106** | 49,590 | 50,535 |
| Amortization of intangible assets | **13,734** | 9,541 | 7,980 |
| All other expense (Note 14) | **340,206** | 300,642 | 393,044 |
| Total noninterest expense | **1,670,932** | 1,504,340 | 1,667,672 |
| **Income before income taxes** | **645,173** | 666,809 | 718,998 |
| Provision for income taxes (Note 16) | **204,075** | 212,401 | 245,689 |
| Income before cumulative effect of changes in accounting principle | **441,098** | 454,408 | 473,309 |
| Cumulative effect of changes in accounting principle, net of tax | **(3,098)** | - | - |
| **Net income** | **$ 438,000** | $ 454,408 | $ 473,309 |
| Earnings per common share before cumulative effect (Note 17) | **$ 3.52** | $ 3.64 | $ 3.73 |
| Earnings per common share from cumulative effect (Note 17) | **(.03)** | - | - |
| **Earnings per common share** (Note 17) | **$ 3.49** | $ 3.64 | $ 3.73 |
| Diluted earnings per common share before cumulative effect (Note 17) | **$ 3.42** | $ 3.54 | $ 3.62 |
| Diluted earnings per common share from cumulative effect (Note 17) | **(.02)** | - | - |
| **Diluted earnings per common share** (Note 17) | **$ 3.40** | $ 3.54 | $ 3.62 |
| **Weighted average common shares** (Note 17) | **125,475** | 124,730 | 126,765 |
| **Diluted average common shares** (Note 17) | **128,950** | 128,436 | 130,876 |

See accompanying notes to consolidated financial statements.
Certain previously reported amounts have been reclassified to agree with current presentation.

# CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

| *(Amounts in thousands)* | Common Shares | Total | Common Stock | Capital Surplus | Undivided Profits | Accumulated Other Comprehensive (Loss)/Income | Deferred Compen-sation | Deferred Compen-sation Obligation |
|---|---|---|---|---|---|---|---|---|
| Balance, December 31, 2002 | 125,600 | $ 1,691,180 | $ 78,500 | $ 119,318 | $ 1,461,946 | $ 26,487 | $ (5,796) | $ 10,725 |
| Net income | - | 473,309 | - | - | 473,309 | - | - | - |
| Other comprehensive income: | | | | | | | | |
| Unrealized fair value adjustments, net of tax: | | | | | | | | |
| Cash flow hedges | - | 137 | - | - | - | 137 | - | - |
| Securities available for sale | - | (24,813) | - | - | - | (24,813) | - | - |
| Minimum pension liability, net of tax | - | (1,129) | - | - | - | (1,129) | - | - |
| Comprehensive income | - | 447,504 | - | - | 473,309 | (25,805) | - | - |
| Cash dividends declared ($1.30/share) | - | (163,452) | - | - | (163,452) | - | - | - |
| Common stock repurchased | (4,855) | (209,125) | (3,035) | (96,972) | (109,118) | - | - | - |
| Common stock issued for stock options and restricted stock | 3,955 | 77,875 | 2,472 | 83,772 | - | - | (8,369) | - |
| Tax benefit from incentive plans | - | 27,842 | - | 27,842 | - | - | - | - |
| Stock-based compensation expense | - | 18,103 | - | 12,982 | - | - | 5,121 | - |
| Other | 134 | 391 | 84 | (1,125) | 14 | - | - | 1,418 |
| Balance, December 31, 2003 | 124,834 | 1,890,318 | 78,021 | 145,817 | 1,662,699 | 682 | (9,044) | 12,143 |
| Net income | - | 454,408 | - | - | 454,408 | - | - | - |
| Other comprehensive income: | | | | | | | | |
| Unrealized fair value adjustments, net of tax: | | | | | | | | |
| Securities available for sale | - | (10,291) | - | - | - | (10,291) | - | - |
| Minimum pension liability, net of tax | - | (319) | - | - | - | (319) | - | - |
| Comprehensive income | - | 443,798 | - | - | 454,408 | (10,610) | - | - |
| Cash dividends declared ($1.63/share) | - | (201,316) | - | - | (201,316) | - | - | - |
| Common stock repurchased | (4,134) | (184,102) | (2,584) | (61,577) | (119,941) | - | - | - |
| Common stock issued for stock options and restricted stock | 2,716 | 67,068 | 1,697 | 66,353 | - | - | (982) | - |
| Tax benefit from incentive plans | - | 15,502 | - | 15,502 | - | - | - | - |
| Stock-based compensation expense | - | 9,712 | - | 7,867 | - | - | 1,845 | - |
| Other | 116 | 3 | 73 | (90) | 3 | - | - | 17 |
| Balance, December 31, 2004 | 123,532 | 2,040,983 | 77,207 | 173,872 | 1,795,853 | (9,928) | (8,181) | 12,160 |
| Net income | - | 438,000 | - | - | 438,000 | - | - | - |
| Other comprehensive income: | | | | | | | | |
| Unrealized fair value adjustments, net of tax: | | | | | | | | |
| Cash flow hedges | - | (77) | - | - | - | (77) | - | - |
| Securities available for sale | - | (32,375) | - | - | - | (32,375) | - | - |
| Minimum pension liability, net of tax | - | 136 | - | - | - | 136 | - | - |
| Comprehensive income | - | 405,684 | - | - | 438,000 | (32,316) | - | - |
| Cash dividends declared ($1.74/share) | - | (217,835) | - | - | (217,835) | - | - | - |
| Common stock repurchased | (11) | (488) | (7) | (481) | - | - | - | - |
| Common stock issued for: | | | | | | | | |
| Stock options and restricted stock | 2,037 | 41,073 | 1,274 | 55,100 | - | - | (15,301) | - |
| Acquisitions | 608 | 24,893 | 380 | 24,513 | - | - | - | - |
| Tax benefit from incentive plans | - | 8,297 | - | 8,297 | - | - | - | - |
| Stock-based compensation expense | - | 9,740 | - | 6,369 | - | - | 3,371 | - |
| Other | 56 | (36) | 35 | 8 | (36) | - | - | (43) |
| **Balance, December 31, 2005** | **126,222** | **$2,312,311** | **$78,889** | **$267,678** | **$2,015,982** | **$(42,244)** | **$(20,111)** | **$12,117** |

See accompanying notes to consolidated financial statements.
Certain previously reported amounts have been reclassified to agree with current presentation.

# CONSOLIDATED STATEMENTS OF CASH FLOWS

| | | Year Ended December 31 | | |
|---|---|---|---|---|
| *(Dollars in thousands)* | | **2005** | 2004 | 2003 |
| **Operating Activities** | Net income | **$ 438,000** | $ 454,408 | $ 473,309 |
| | Adjustments to reconcile net income to net cash provided/(used) by operating activities: | | | |
| | Provision for loan losses | **67,678** | 48,348 | 86,698 |
| | Provision for deferred income tax | **35,586** | 41,472 | 113,716 |
| | Depreciation and amortization of premises and equipment | **51,844** | 48,731 | 45,087 |
| | Amortization and impairment of mortgage servicing rights | **230,044** | 191,363 | 290,597 |
| | Amortization of intangible assets | **13,734** | 9,541 | 7,980 |
| | Net other amortization and accretion | **90,572** | 74,950 | 81,567 |
| | Decrease in derivatives, net | **142,769** | 159,123 | 58,298 |
| | Market value adjustment on foreclosed property | **6,314** | 4,022 | 11,644 |
| | Cumulative effect of changes in accounting principle, net of tax | **3,098** | - | - |
| | Gain on divestiture | **(7,029)** | (7,000) | (22,498) |
| | Loss on early retirement of debt | **-** | - | 5,766 |
| | Equity securities losses/(gains), net | **579** | (2,040) | (8,491) |
| | Debt securities (gains)/losses, net | **(1)** | (18,708) | 6,113 |
| | Net losses/(gains) on disposals of fixed assets | **566** | (589) | 1,437 |
| | Net (increase)/decrease in: | | | |
| | Trading securities | **(455,467)** | (187,525) | 85,374 |
| | Loans held for sale | **423,719** | (566,337) | 1,819,842 |
| | Capital markets receivables | **(235,210)** | 321,123 | (327,190) |
| | Interest receivable | **(58,610)** | (19,528) | (8,369) |
| | Other assets | **(747,923)** | (724,706) | (427,934) |
| | Net increase/(decrease) in: | | | |
| | Capital markets payables | **201,004** | (314,578) | 282,070 |
| | Interest payable | **50,736** | 12,504 | 579 |
| | Other liabilities | **(120,571)** | 123,931 | (5,842) |
| | Trading liabilities | **367,295** | 298,625 | (88,563) |
| | Total adjustments | **60,727** | (507,278) | 2,007,881 |
| | Net cash provided/(used) by operating activities | **498,727** | (52,870) | 2,481,190 |
| **Investing Activities** | Maturities of held to maturity securities | **60** | 589 | 142,723 |
| | Available for sale securities: | | | |
| | Sales | **67,729** | 1,298,485 | 992,017 |
| | Maturities | **481,028** | 415,647 | 1,546,914 |
| | Purchases | **(830,539)** | (1,920,053) | (2,745,032) |
| | Premises and equipment: | | | |
| | Sales | **744** | 1,048 | 847 |
| | Purchases | **(95,661)** | (78,763) | (149,600) |
| | Net increase in loans | **(3,878,845)** | (4,165,896) | (2,808,349) |
| | Net (increase)/decrease in investment in bank time deposits | **(5,358)** | (4,831) | 1,346 |
| | Proceeds from divestitures, net of cash and cash equivalents | **19,100** | 7,000 | 21,577 |
| | Acquisitions, net of cash and cash equivalents acquired | **(841,950)** | - | (1,930) |
| | Net cash used by investing activities | **(5,083,692)** | (4,446,774) | (2,999,487) |
| **Financing Activities** | Common stock: | | | |
| | Exercise of stock options | **41,289** | 67,935 | 77,591 |
| | Cash dividends paid | **(214,024)** | (198,495) | (150,863) |
| | Repurchase of shares | **(488)** | (184,224) | (209,263) |
| | Term borrowings: | | | |
| | Issuance | **1,923,750** | 1,506,605 | 925,887 |
| | Payments | **(1,074,555)** | (610,585) | (287,207) |
| | Issuance of preferred stock of subsidiary | **295,400** | - | 260 |
| | Net increase/(decrease) in: | | | |
| | Deposits | **3,597,156** | 3,910,748 | 45,770 |
| | Short-term borrowings | **1,127,558** | 173,365 | (57,801) |
| | Net cash provided by financing activities | **5,696,086** | 4,665,349 | 344,374 |
| | Net increase/(decrease) in cash and cash equivalents | **1,111,121** | 165,705 | (173,923) |
| | Cash and cash equivalents at beginning of period | **1,320,499** | 1,154,794 | 1,328,717 |
| | Cash and cash equivalents at end of period | **$2,431,620** | $ 1,320,499 | $ 1,154,794 |
| | Total interest paid | **$ 804,574** | $ 297,089 | $ 246,136 |
| | Total income taxes paid | **200,176** | 182,255 | 159,188 |

See accompanying notes to consolidated financial statements.

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

# Notes to Consolidated Financial Statements

## Note 1 ❑ Summary of Significant Accounting Policies

***Basis of Accounting.*** The 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.

***Principles of Consolidation and Basis of Presentation.*** The consolidated financial statements include the accounts of FHN and other entities in which it has a controlling financial interest. Variable Interest Entities (VIE) for which FHN or a subsidiary has been determined to be the primary beneficiary are also consolidated. Affiliates for which FHN is not considered the primary beneficiary and that FHN does not have a controlling financial interest in are accounted for by the equity method. These investments are included in other assets, and FHN's proportionate share of income or loss is included in noninterest income. All significant intercompany transactions and balances have been eliminated. For purposes of comparability, certain prior period amounts have been reclassified to conform to current year presentation. None of these reclassifications had any effect on net income or earnings per share for any of the periods presented. Business combinations accounted for as purchases are included in the financial statements from the respective dates of acquisition.

***Revenue Recognition.*** FHN derives a significant portion of its revenues from fee based services. Noninterest income from transaction based fees is generally recognized when the transactions are completed. Noninterest income from service based fees is generally recognized over the period in which FHN provides the service.

***Deposit Transactions and Cash Management.*** Deposit transactions include services related to retail deposit products (such as service charges on checking accounts), cash management products and services such as electronic transaction processing (automated clearing house and Electronic Data Interchange), account reconciliation services, cash vault services, lockbox processing, and information reporting to large corporate clients.

***Merchant Processing.*** Merchant processing involves converting transactions from plastic media such as debit cards, credit cards, purchase cards, and private label credit cards into cash for merchants that sell goods and services to consumers and businesses.

***Insurance Commissions.*** Insurance commissions are derived from the sale of insurance products, including acting as an independent agent to provide commercial and personal property and casualty, life, long-term care, and disability insurance.

***Trust Services and Investment Management.*** Trust services and investment management fees include investment management, personal trust, employee benefits, and custodial trust services.

***Statements of Cash Flows.*** For purposes of these statements, cash and due from banks, federal funds sold, and securities purchased under agreements to resell are considered cash and cash equivalents. Federal funds are usually sold for one-day periods, and securities purchased under agreements to resell are short-term, highly liquid investments.

***Trading Activities.*** Securities purchased in connection with underwriting or dealer activities (long positions) are carried at market value as trading securities. Gains and losses, both realized and unrealized, on these securities are reflected in capital markets noninterest income. Trading liabilities include securities that FHN has sold to other parties but does not own (short positions). FHN is obligated to purchase securities at a future date to cover the short positions. Assets and liabilities for unsettled trades are recorded on the balance sheet as capital markets receivables or capital markets payables. Retained interests, in the form of interest-only and principal-only strips, and subordinated securities from securitizations of first-lien mortgages are recognized at fair value as trading securities with gains and losses, both realized and unrealized, recognized in mortgage banking income. Retained interests, in the form of certificated residual interests from the securitization of second-lien mortgages and HELOC are recognized at fair value as trading securities with gains and losses, both realized and unrealized, recognized in revenue from loans sales and securitizations.

***Investment Securities.*** Securities that FHN has the ability and positive intent to hold to maturity are classified as securities held to maturity and are carried at amortized cost. The amortized cost of all securities is adjusted for amortization of premium and accretion of discount to maturity, or earlier call date if appropriate, using the level yield method. Such amortization and accretion is included in interest income from securities. Investment securities are reviewed quarterly for possible other-than-temporary impairment. The review includes an analysis of the facts and circumstances of each individual investment such as the degree of loss, the length of time the fair value has been below cost, the expectation for that security's performance, the creditworthiness of the issuer and FHN's intent and ability to hold the security. Realized gains and losses and declines in value judged to be other-than-temporary are determined by the specific identification method and reported in noninterest income.

Securities that may be sold prior to maturity and equity securities are classified as securities available for sale and are carried at fair value. The unrealized gains and losses on securities available for sale are excluded from earnings and are reported, net of tax, as a component of other comprehensive income within shareholders' equity. Venture capital investments for which there are not active market quotes are initially valued at cost. Subsequently, these investments are adjusted to reflect changes in valuation as a result of initial public offerings or other-than-temporary declines in value.

***Securities Purchased under Resale Agreements and Securities Sold under Repurchase Agreements.*** FHN enters into short-term purchases of securities under agreements to resell which are accounted for as collateralized financings except where FHN does not have an agreement to sell the same or substantially the same securities before maturity at a fixed or determinable price. Securities delivered under these transactions are delivered to either the dealer custody account at the Federal Reserve Bank or to the applicable counterparty. Collateral is valued daily and FHN may require counterparties to deposit additional collateral or return collateral pledged when appropriate.

Securities sold under agreements to repurchase are offered to cash management customers as an automated, collateralized investment account. Securities sold are also used by the retail/commercial bank to obtain favorable borrowing rates on its purchased funds.

***Loans Held for Sale and Securitization and Residual Interests.*** FHN's mortgage lenders originate first-lien mortgage loans (the warehouse) for the purpose of selling them in the secondary market, primarily through proprietary and agency securitizations, and to a lesser extent through loan sales. In addition, FHN evaluates its liquidity position in conjunction with determining its ability and intent to hold loans for the foreseeable future and sells certain of the second-lien mortgages and HELOC it produces in the secondary market through securitizations and loan sales. Loan securitizations involve the transfer of the loans to qualifying special purposes entities (QSPE) that are not subject to consolidation in accordance with Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (SFAS No. 140). FHN generally retains the right to service the transferred loans.

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

Mortgage loans insured by the Federal Housing Administration (FHA) and mortgage loans guaranteed by the Veterans Administration (VA) are generally securitized through the Government National Mortgage Association (GNMA). Conforming conventional loans are generally securitized through government-sponsored enterprises (GSE) such as the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). In addition, FHN has completed proprietary securitizations of nonconforming first-lien and second-lien mortgages and HELOC, which do not conform to the requirements for sale or securitization through government agencies or GSE. Retained interests include mortgage servicing rights (MSR), interest-only and principal-only securities, subordinate securities, and certificated residual interests.

The retained interests are initially valued by allocating the total cost basis of the loan between the security or loan sold and the retained interests based on their relative fair values at the time of securitization or sale. The retained interests, other than MSR, are carried at fair value as a component of trading securities on the Consolidated Statements of Condition, with realized and unrealized gains and losses included in current earnings as a component of noninterest income on the Consolidated Statements of Income.

Retained interests in a securitization may include certificated residual interests, or financial assets including excess interest (structured as interest-only strips), interest-only strips, principal-only strips, or subordinated bonds. Residual interests are financial assets, which represent rights to receive earnings to the extent of excess income generated by the underlying loans. Excess interest is a financial asset that represents rights to receive interest from serviced assets that exceed contractually specified rates. Principal-only strips are financial assets, which represent principal cash flow tranches retained as a result of FHN’s securitization transactions. Interest-only strips are financial assets, which represent interest cash flow tranches retained as a result of FHN’s securitization transactions. Subordinated bonds are bonds with junior priority which are retained as a result of securitization. All retained interests are recognized on the balance sheet in trading securities at fair value.

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

MSR are initially valued by allocating the total cost between the loan and the servicing right based on their relative fair values. 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 numerous tranches of MSR, which share similar key characteristics 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 on a quarterly basis. FHN also compares its estimates of fair value and assumptions to recent market activity and against its own experience.

## Note 1 ❑ Summary of Significant Accounting Policies (continued)

MSR are periodically evaluated for impairment. Impairment occurs when the current fair value of the retained interest is less than its recorded value. For purposes of impairment evaluation and measurement, the MSR are stratified based on the predominant risk characteristics of the underlying loans. These strata currently include adjustable and fixed rate loans. The MSR are amortized over the period of and in proportion to the estimated net servicing revenues. A quarterly value impairment analysis is performed using a discounted cash flow methodology that is disaggregated by predominant risk characteristics. Impairment, if any, is recognized through a valuation allowance for individual strata. However, if the impairment is determined to be other than temporary, a direct write-off of the asset is made. The cost basis of MSR qualifying for SFAS No. 133 fair value hedge accounting is adjusted to reflect changes in fair value.

***Loans.*** Loans are stated at principal amounts outstanding, net of unearned income. Interest on loans is recognized on an accrual basis at the applicable interest rate on the principal amount outstanding. Loan origination fees and direct costs as well as premiums and discounts are amortized as level yield adjustments over the respective loan terms. Unamortized net fees or costs are recognized upon early repayment of the loans. Loan commitment fees are generally deferred and amortized on a straight-line basis over the commitment period. Impaired loans are generally carried on a nonaccrual status. Loans are ordinarily placed on nonaccrual status when, in management's opinion, the collection of principal or interest is unlikely, the loan has been classified as "doubtful", or when the collection of principal or interest is 90 days or more past due. Accrued but uncollected interest is reversed and charged against interest income when the loan is placed on nonaccrual status. On retail loans, accrued but uncollected interest is reversed when the loan is fully or partially charged off. Management may elect to continue the accrual of interest when the estimated net realizable value of collateral is sufficient to recover the principal balance and accrued interest. Interest payments received on nonaccrual and impaired loans are normally applied to principal. Once all principal has been received, additional interest payments are recognized on a cash basis as interest income.

***Allowance for Loan Losses.*** The allowance for loan losses is maintained at a level that management determines is adequate to absorb estimated probable incurred losses in the loan portfolio. Management's evaluation process to determine the adequacy of the allowance utilizes an analytical model based on historical loss experience, adjusted for current events, trends and economic conditions. The actual amounts realized could differ in the near term from the amounts assumed in arriving at the allowance for loan losses reported in the financial statements.

All losses of principal are charged to the allowance for loan losses in the period in which the loan is deemed to be uncollectible. Additions are made to the allowance through periodic provisions charged to current operations and recovery of principal on loans previously charged off.

***Premises and Equipment.*** Premises and equipment are carried at cost less accumulated depreciation and amortization and include additions that materially extend the useful lives of existing premises and equipment. All other maintenance and repair expenditures are expensed as incurred. Gains and losses on dispositions are reflected in noninterest income and expense.

Depreciation and amortization are computed on the straight-line method over the estimated useful lives of the assets and are recorded as noninterest expense. Leasehold improvements are amortized over the lesser of the lease periods or the estimated useful lives using the straight-line method. Useful lives utilized in determining depreciation for furniture, fixtures and equipment and buildings are three to fifteen and seven to forty-five years, respectively.

***Real Estate Acquired by Foreclosure.*** Real estate acquired by foreclosure consists of properties that have been acquired in satisfaction of debt. These properties are carried at the lower of the outstanding loan amount or estimated fair value less estimated cost to sell the real estate. Losses arising at foreclosure are charged to the appropriate reserve. Required developmental costs associated with foreclosed property under construction are capitalized and included in determining the estimated net realizable value of the property, which is reviewed periodically, and any write-downs are charged against current earnings. During the normal course of business, FHN may purchase real estate at foreclosure sale. Losses arising from the purchase of real estate at foreclosure sale are charged to the foreclosure reserve.

***Intangible Assets.*** Intangible assets consist of "Other intangible assets" and "Goodwill." The "Other intangible assets" represents identified intangible assets, including customer lists, acquired contracts, covenants not to compete and premium on purchased deposits, which are amortized over their estimated useful lives, except for those assets related to deposit bases that are primarily amortized over 10 years. Management evaluates whether events or circumstances have occurred that indicate the remaining useful life or carrying value of amortizing intangibles should be revised. "Goodwill" represents the excess of cost over net assets of acquired subsidiaries less identifiable intangible assets. On an annual basis, FHN tests goodwill for impairment. For the three year period ended December 31, 2005, no impairment of "Other intangible assets" or "Goodwill" was recognized.

***Derivative Financial Instruments.*** FHN accounts for derivative financial instruments in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended. SFAS No. 133 requires recognition of all derivative instruments on the balance sheet as either an asset or liability measured at fair value through adjustments to either accumulated other comprehensive income within shareholders' equity or current earnings. 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.

FHN prepares written hedge documentation, identifying the risk management objective and designating the derivative instrument as a fair value hedge, cash flow hedge or free-standing derivative instrument entered into as an economic hedge or to meet customers' needs. All transactions designated as SFAS No. 133 hedges must be assessed at inception and on an ongoing basis as to the effectiveness of the derivative instrument in offsetting changes in fair value or cash flows of the hedged item. 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, is recorded in accumulated other comprehensive income and subsequently reclassified to earnings as the hedged transaction impacts net income. Any ineffective portion of a cash flow hedge is recognized currently in earnings. For free-standing derivative instruments, changes in fair values are recognized currently in earnings. See Note 25–Derivatives and Off-Balance Sheet Arrangements for additional information.

Cash flows from derivative contracts are reported as operating activities on the Consolidated Statements of Cash Flows.

***Advertising and Public Relations.*** Advertising and public relations costs are generally expensed as incurred.

***Income Taxes.*** FHN accounts for income taxes using the liability method pursuant to SFAS No. 109, "Accounting for Income Taxes". Under this method, FHN's deferred tax assets and liabilities are determined by applying the applicable federal and state income tax rates to its cumulative temporary differences. These temporary differences represent differences between financial statement carrying amounts and the corresponding tax bases of certain assets and liabilities. Deferred taxes are provided as a result of such temporary differences.

FHN and its eligible subsidiaries are included in a consolidated federal income tax return. FHN files separate returns for subsidiaries that are not eligible to be included in a consolidated federal income tax return. Based on the laws of the applicable state where it conducts business operations, FHN either files consolidated, combined or separate returns.

FHN's federal and state income tax returns are subject to examination by governmental authorities. Various examinations are currently in progress. FHN believes that the resolution of both the examinations in progress and the examination of years not currently in progress will not have a significant impact on FHN's consolidated financial position or results of operations.

***Earnings per Share.*** Earnings per share are computed by dividing net income by the weighted average number of common shares outstanding for each period. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares adjusted to include the number of additional common shares that would have been outstanding if the dilutive potential common shares resulting from options granted under FHN's stock option plans and deferred compensation arrangements had been issued. FHN utilizes the treasury stock method in this calculation.

***Stock Options.*** FHN accounts for its employee stock-based compensation plans under the intrinsic value based method in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB No. 25). The following pro forma presentation of net income and earnings per share is determined utilizing various assumptions and estimates and is based on stock compensation plan provisions in effect during the reportable period and may not reflect the actual impact of adopting a fair value based method of accounting for stock options. Had compensation cost for these plans been determined consistent with SFAS No. 123, "Accounting for Stock-Based Compensation" (SFAS No. 123), FHN's net income and earnings per share would have been reduced to pro forma amounts provided in the table below:

| | December 31 | | |
|---|---|---|---|
| *(Dollars in thousands except per share data)* | **2005** | 2004 | 2003 |
| Net income, as reported | **$438,000** | $454,408 | $473,309 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | **2,895** | 3,414 | 6,402 |
| Less: Total stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects | **16,198** | 12,114 | 27,139 |
| Pro forma net income | **$424,697** | $445,708 | $452,572 |
| Earnings per share, as reported | **$ 3.49** | $ 3.64 | $ 3.73 |
| Pro forma earnings per share | **3.38** | 3.57 | 3.57 |
| Diluted earnings per share, as reported | **3.40** | 3.54 | 3.62 |
| Pro forma diluted earnings per share | **3.28** | 3.47 | 3.46 |

For all stock option awards accounted for under APB No. 25 and disclosed under SFAS No. 123, FHN permits vesting of the option to continue after retirement. To account for its stock option awards, FHN uses the nominal vesting period approach. Under the nominal vesting period approach, awards granted to employees near retirement eligibility are expensed over the option's normal vesting period until an employee's actual retirement date, at which point all remaining unamortized compensation expense is immediately accelerated. Awards granted after the adoption of SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123-R) will be amortized using the nonsubstantive vesting methodology. The nonsubstantive vesting methodology requires an option's value to be recognized over a period ending no later than an employee's retirement eligibility date. Had FHN followed the nonsubstantive vesting period method for all awards previously granted, the effect of the change in expense attribution on the above pro forma diluted earnings per share amounts would have been negligible. Since FHN accounts for its option grants under APB No. 25, the use of the nominal vesting methodology had no impact on the earnings per share amounts presented in the accompanying statements of income.

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

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

In November 2005, the FASB issued FSP FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" (FSP FAS 115-1), which supercedes the previously deferred recognition guidance of EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" (EITF 03-1). FSP FAS 115-1 is effective January 1, 2006, and references previously existing GAAP. Therefore, adoption of FSP FAS 115-1 did not impact FHN's accounting for other-than-temporary impairment of investments. Effective July 1, 2004, FHN adopted the remaining provisions of EITF 03-1, including guidance for measuring and disclosing impairments of marketable securities and cost method investments. Adoption of these requirements did not have a material effect on the results of operations.

On July 1, 2004, FHN adopted FASB Staff Position FAS 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003" (FSP FAS 106-2). FSP FAS 106-2 requires a plan sponsor to determine if benefits offered through a postretirement health care plan are actuarially equivalent to Medicare Part D. If benefits are determined to be actuarially equivalent, the resulting effect on the plan's obligations should be reflected as an actuarial gain in determining the plan's accumulated postretirement benefit obligation. The impact of adopting FSP FAS 106-2 was immaterial to FHN.

In April 2004, FHN adopted Staff Accounting Bulletin No. 105, "Application of Accounting Principles to Loan Commitments" (SAB No. 105). SAB No. 105 prohibits the inclusion of estimated servicing cash flows and internally-developed intangible assets within the valuation of interest rate lock commitments under SFAS No. 133. SAB No. 105 also requires disclosure of a registrant's methods of accounting for interest rate lock commitments recognized under SFAS No. 133 and associated hedging strategies, if applicable. SAB No. 105 was effective for disclosures and interest rate lock commitments initiated after March 31, 2004. The adoption of SAB No. 105 resulted in an accounting change in 2004 and lowered pre-tax earnings by $8.4 million. Since prior periods were not restated, this accounting change resulted in a varying impact on comparability with prior periods. However, the ongoing economic value of FHN's business was not affected.

On March 31, 2004, FHN adopted FASB Interpretation No. 46 (revised 2003), "Consolidation of Variable Interest Entities," (FIN 46-R), which clarified certain aspects of FIN 46, and on December 31, 2003, adopted FIN 46, which addressed consolidation by a business enterprise of VIE in which it is the primary beneficiary. Upon adoption of FIN 46, FHN deconsolidated its subsidiary, First Tennessee Capital I (Capital I), which has issued $100.0 million of capital securities that are fully and unconditionally guaranteed by FHN. FHN did not consolidate or deconsolidate any other significant VIE in connection with the adoption of FIN 46, and accordingly, it did not have a material impact on FHN's financial position or results of operations. Upon adoption of FIN 46-R, FHN reassessed certain of its nonconsolidated interests as VIE but did not meet the criteria of primary beneficiary and, therefore, did not consolidate or deconsolidate any other significant VIE, and accordingly, it did not have a material impact on FHN's financial position or results of operations. See Note 25–Derivatives and Off-Balance Sheet Arrangements for additional information.

On December 31, 2003, FHN adopted SFAS No. 132 (revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits" (SFAS No. 132-R). This standard does not change the measurement or recognition of those plans required by SFAS No. 87 and SFAS No. 106. Additionally, the disclosure requirements of the original SFAS No. 132 have been retained. SFAS No. 132-R requires additional disclosure about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans. The adoption of SFAS No. 132 (revised 2003) did not have an impact on the results of operations.

On July 1, 2003, FHN adopted SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" (SFAS No. 150), and classified $45.1 million of mandatorily redeemable preferred stock of subsidiary as term borrowings. Historically, the related distributions on these instruments were classified as noninterest expense on the Consolidated Statements of Income, but as of July 1, 2003, were classified as interest expense on a prospective basis. As required by SFAS No. 150, prior periods were not restated.

On July 1, 2003, FHN adopted SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments," which amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133. The impact of adopting this standard was immaterial to FHN.

On January 1, 2003, FHN adopted SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." This statement requires that a liability for the cost associated with an exit or disposal activity be recognized and measured initially at fair value in the period in which the liability is incurred. Prior to the effective date of this statement, costs associated with an exit or disposal plan were recognized at the date of commitment, as required under EITF Issue 94-3. This statement does not apply to costs associated with an exit activity that involves an entity newly acquired in a business combination or with a disposal activity covered by SFAS No. 144. The impact of adopting this statement was immaterial to FHN.

On January 1, 2003, FHN adopted the final provisions of FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." This interpretation elaborates on the disclosures to be made by a guarantor in interim and annual financial statements about obligations assumed under certain guarantees it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. This interpretation does not prescribe a specific approach for subsequently measuring the guarantor's liability over the term of the related guarantee. This interpretation also incorporates, without change, the guidance in FASB Interpretation No. 34, "Disclosure of Indirect Guarantees of Indebtedness of Others," which is superseded. The impact of adopting this statement was immaterial to FHN.

***Accounting Changes Issued but Not Currently Effective.*** In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments," which permits fair value remeasurement for any 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. SFAS No. 155 is effective for fiscal years beginning after September 15, 2006. Since FHN accounts for its beneficial interests in securitizations as trading securities, the adoption of SFAS No. 155 is not expected to have a significant impact on the results of operations.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" (SFAS No. 154), which 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

## Note 1 ❑ Summary of Significant Accounting Policies (continued)

specified, SFAS No. 154's retrospective application requirement will apply. SFAS No. 154 does not alter the accounting requirement for changes in estimates (prospective) and error corrections (restatement). SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005.

In December 2004, the FASB issued SFAS No. 123-R, which requires recognition of expense over the requisite service period for awards of share-based compensation to employees. Due to SEC action in April 2005, the mandatory adoption date for SFAS No. 123-R was moved to January 1, 2006 with earlier adoption permitted. As permitted by the original SFAS No. 123, FHN has accounted for its equity awards under the provisions of APB No. 25. Upon adoption of SFAS No. 123-R, the grant date fair value of an award will be used to measure the compensation expense recognized for the award. For unvested awards granted prior to the adoption of SFAS No. 123-R, the fair values utilized will equal the values used in preparation of the disclosures required under the original SFAS No. 123. Compensation expense recognized after adoption of SFAS No. 123-R will incorporate 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. Upon initial adoption of SFAS No. 123-R, FHN is required to reclassify deferred compensation balances included in shareholders' equity to capital surplus and to make a cumulative effect adjustment for outstanding unvested awards that are not expected to vest due to anticipated forfeiture. As permitted by SFAS No. 123-R, FHN intends to retroactively apply the provisions of SFAS No. 123-R to its prior period financial statements.

## Note 2 ❑ Acquisitions/Divestitures

On March 1, 2006, FHN sold substantially all the assets of its national merchant processing business conducted primarily through First Horizon Merchant Services, Inc. (FHMS) and Global Card Services, Inc. The sale is to NOVA Information Systems (NOVA), a wholly-owned subsidiary of U.S. Bancorp. This transaction resulted in a pre-tax gain of approximately $340 million. In addition, a supplement to the purchase price may be paid to FHN if certain performance goals are achieved during a period following closing. This divestiture will be accounted for as a discontinued operation, and prior periods will be adjusted to exclude the impact of merchant operations from the results of continuing operations. Financial information for discontinued operations is summarized below:

| | Year Ended December 31 | | |
|---|---|---|---|
| *(Dollars in thousands)* | **2005** | 2004 | 2003 |
| Total revenues | **$89,169** | $87,155 | $78,187 |
| Total expenses | **61,931** | 56,403 | 56,564 |
| **Income before income taxes** | **27,238** | 30,752 | 21,623 |
| Provision for income taxes | **10,165** | 11,477 | 7,951 |
| **Net income from discontinued operations** | **$17,073** | $19,275 | $13,672 |

Total average assets for merchant operations were $200.8 million and $121.8 million for December 31, 2005 and 2004, respectively.

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

On August 26, 2005, FHN acquired West Metro Financial Services Inc. (West Metro), a Georgia bank holding company. West Metro was merged with and into FHN. At the same time West Metro's subsidiary, First National Bank West Metro, with total assets of approximately $135 million, loans of approximately $115 million, and deposits of approximately $120 million, was merged with and into FTBNA. Total consideration of $32 million, consisting of approximately $11 million in cash and $21

### Note 2 ❑ Acquisitions/Divestitures (continued)

million in FHN shares (approximately 518,000 shares of common stock), exceeded the estimated fair value of tangible assets and liabilities acquired by approximately $16 million. Intangible assets totaling approximately $3 million have been identified and are being amortized over their expected useful lives. The acquisition was immaterial to FHN.

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

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

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

On December 31, 2004, Synaxis Group, Inc., a subsidiary of FTBNA, completed the sale of substantially all the assets of Mann, Smith & Cummings, Inc. of Clarksville, TN. This transaction resulted in a divestiture gain of $1.2 million.

On September 23, 2004, FTN Midwest Securities Corp., a wholly-owned subsidiary of FTBNA, acquired certain assets and assumed certain liabilities of Alterity Partners, LLC, a mergers and acquisitions advisory services company based in New York, New York, for approximately $8.0 million in cash. The acquisition was immaterial to FHN.

On June 29, 2004, FHMS recognized a divestiture gain of $1.8 million resulting from the sale of certain merchant relationships to Humboldt Merchant Services, LP, of Eureka, California (an affiliate of First National Bank of Nevada, Reno, Nevada).

On December 31, 2003, FHN completed the sale of substantially all of the assets and liabilities of its wholly-owned subsidiary, First National Bank of Springdale (FNB) of Springdale, Arkansas to First Security Bank of Searcy, Arkansas. This transaction resulted in a divestiture gain of $12.5 million. Immediately preceding the sale, FNB had investment securities of approximately $125 million, loans of approximately $165 million, deposits of approximately $300 million and equity of approximately $40 million.

On December 31, 2003, FHMS recognized a divestiture gain of $10.0 million resulting from the sale of certain merchant relationships referred by selected agent banks within the merchant portfolio to NOVA. During 2004, divestiture gains of $4.0 million resulted from an earn-out on the 2003 sale of merchant relationships.

On August 1, 2003, FHMS acquired Global Card Services, Inc., a merchant processing company based in Orlando, Florida, for approximately $15.8 million in cash. The acquisition was immaterial to FHN.

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

## Note 3 ❑ Investment Securities

The following tables summarize FHN's securities held to maturity and available for sale on December 31, 2005 and 2004:

| | **On December 31, 2005*** | | | |
|---|---|---|---|---|
| | | Gross | Gross | |
| | Amortized | Unrealized | Unrealized | Fair |
| *(Dollars in thousands)* | Cost | Gains | Losses | Value |
| **Securities held to maturity:** | | | | |
| States and municipalities | $ 383 | $ 7 | $ - | $ 390 |
| Total securities held to maturity | **$ 383** | **$ 7** | **$ -** | **$ 390** |
| **Securities available for sale:** | | | | |
| U.S. Treasuries | $ 41,190 | $ 5 | $ (82) | $ 41,113 |
| Government agency issued MBS** | 920,105 | 319 | (27,765) | 892,659 |
| Government agency issued CMO** | 1,667,312 | 985 | (35,091) | 1,633,206 |
| Other U.S. government agencies** | 136,341 | - | (2,423) | 133,918 |
| States and municipalities | 2,115 | 27 | - | 2,142 |
| Other | 9,209 | 9 | (50) | 9,168 |
| Equity | 200,422 | 51 | (576) | 199,897 |
| Total securities available for sale | **$2,976,694** | **$1,396** | **$(65,987)** | **$2,912,103** |

* Includes $2.5 billion of securities pledged to secure public deposits, securities sold under agreements to repurchase and for other purposes.

** Includes securities issued by government sponsored entities which are not backed by the full faith and credit of the U.S. government.

| | On December 31, 2004* | | | |
|---|---|---|---|---|
| | | Gross | Gross | |
| | Amortized | Unrealized | Unrealized | Fair |
| *(Dollars in thousands)* | Cost | Gains | Losses | Value |
| **Securities held to maturity:** | | | | |
| States and municipalities | $ 441 | $ 16 | $ - | $ 457 |
| Total securities held to maturity | $ 441 | $ 16 | $ - | $ 457 |
| **Securities available for sale:** | | | | |
| U.S. Treasuries | $ 41,423 | $ 11 | $ (190) | $ 41,244 |
| Government agency issued MBS** | 881,888 | 668 | (7,937) | 874,619 |
| Government agency issued CMO** | 1,521,088 | 1,505 | (6,050) | 1,516,543 |
| Other U.S. government agencies** | 40,794 | 165 | - | 40,959 |
| States and municipalities | 7,704 | 125 | (2) | 7,827 |
| Other | 7,272 | 105 | (7) | 7,370 |
| Equity | 191,994 | 8 | (8) | 191,994 |
| Total securities available for sale | $ 2,692,163 | $ 2,587 | $ (14,194) | $ 2,680,556 |

* Includes $2.4 billion of securities pledged to secure public deposits, securities sold under agreements to repurchase and for other purposes.

** Includes securities issued by government sponsored entities which are not backed by the full faith and credit of the U.S. government.

## Note 3 ❑ Investment Securities (continued)

Provided below are the amortized cost and fair value by contractual maturity for the securities portfolios on December 31, 2005:

| | Held to Maturity | | Available for Sale | |
|---|---|---|---|---|
| *(Dollars in thousands)* | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Within 1 year | $100 | $101 | $ 13,678 | $ 13,661 |
| After 1 year; within 5 years | 283 | 289 | 95,277 | 94,490 |
| After 5 years; within 10 years | - | - | 77,785 | 76,048 |
| After 10 years | - | - | 2,115 | 2,142 |
| Subtotal | 383 | 390 | 188,855 | 186,341 |
| Government agency issued MBS and CMO | - | - | 2,587,417 | 2,525,865 |
| Equity securities | - | - | 200,422 | 199,897 |
| Total | **$383** | **$390** | **$2,976,694** | **$2,912,103** |

Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

The table below provides information on realized gross gains and realized gross losses on sales from the available for sale portfolio for the years ended December 31:

| *(Dollars in thousands)* | AFS Debt* | AFS Equity* | Total |
|---|---|---|---|
| **2005** | | | |
| Gross gains on sales | $ 1 | $ 62 | $ 63 |
| 2004 | | | |
| Gross gains on sales | $18,712 | $ 6,593 | $25,305 |
| Gross losses on sales | (4) | (653) | (657) |
| 2003 | | | |
| Gross gains on sales | $ 847 | $11,444 | $12,291 |
| Gross losses on sales | (6,973) | - | (6,973) |

* AFS - Available for sale

Losses totaling $.6 million, $3.9 million and $3.0 million for the years 2005, 2004 and 2003, respectively, were recognized for securities that, in the opinion of management, have been other-than-temporarily impaired.

## Note 3 ❑ Investment Securities (continued)

The following table provides information on investments that have unrealized losses on December 31, 2005 and 2004:

| | **On December 31, 2005** | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 Months or Longer | | Total | |
| *(Dollars in thousands)* | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasuries | $ 39,573 | $ (66) | $ 363 | $ (16) | $ 39,936 | $ (82) |
| Government agency issued MBS | 294,513 | (6,781) | 592,307 | (20,984) | 886,820 | (27,765) |
| Government agency issued CMO | 703,810 | (13,805) | 744,792 | (21,286) | 1,448,602 | (35,091) |
| Other U.S. government agencies | 133,918 | (2,423) | - | - | 133,918 | (2,423) |
| Other | 7,650 | (32) | 836 | (18) | 8,486 | (50) |
| Total debt securities | 1,179,464 | (23,107) | 1,338,298 | (42,304) | 2,517,762 | (65,411) |
| Equity | 26,605 | (576) | - | - | 26,605 | (576) |
| Total temporarily impaired securities | **$1,206,069** | **$(23,683)** | **$1,338,298** | **$(42,304)** | **$2,544,367** | **$(65,987)** |

The gross unrealized losses on December 31, 2005, principally related to U.S. Government agencies, were primarily caused by interest rate changes. FHN has reviewed these securities in accordance with its accounting policy for other-than-temporary impairment and does not consider them other-than-temporarily impaired.

| | On December 31, 2004 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 Months or Longer | | Total | |
| *(Dollars in thousands)* | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasuries | $ 34,901 | $ (181) | $ 170 | $ (9) | $ 35,071 | $ (190) |
| Government agency issued MBS | 832,535 | (7,655) | 16,192 | (282) | 848,727 | (7,937) |
| Government agency issued CMO | 908,590 | (6,050) | - | - | 908,590 | (6,050) |
| State and municipalities | 663 | (2) | - | - | 663 | (2) |
| Other | 861 | (7) | - | - | 861 | (7) |
| Total debt securities | 1,777,550 | (13,895) | 16,362 | (291) | 1,793,912 | (14,186) |
| Equity | 226 | (8) | - | - | 226 | (8) |
| Total temporarily impaired securities | $ 1,777,776 | $ (13,903) | $ 16,362 | $ (291) | $ 1,794,138 | $ (14,194) |

On December 31, 2004, FHN held two investment securities having continuous unrealized loss positions for more than 12 months. The unrealized losses were related to changes in interest rates. FHN has not recognized any other-than-temporary impairment in connection with these securities.

On December 31, 2005 and 2004, FHN had $143.2 million and $125.2 million, respectively, of cost method investments. These investments included Federal Reserve Bank and Federal Home Loan Bank stock of $108.2 million and $94.1 million on December 31, 2005 and 2004, respectively. These investments, which do not have a readily determinable market and for which it is not practicable to estimate a fair value, are evaluated for impairment only if there are identified events or changes in circumstances that may have had a significant adverse effect on the fair value of the investment.

## Note 4 ❑ Loans

A summary of the major categories of loans outstanding on December 31 is shown below:

| *(Dollars in thousands)* | **2005** | 2004 |
|---|---|---|
| Commercial: | | |
| Commercial, financial and industrial | **$ 6,578,130** | $ 5,560,736 |
| Real estate commercial | **1,213,052** | 960,178 |
| Real estate construction | **2,108,121** | 1,208,703 |
| Retail: | | |
| Real estate residential | **8,357,143** | 7,244,716 |
| Real estate construction | **1,925,060** | 1,035,562 |
| Other retail | **168,413** | 168,806 |
| Credit card receivables | **251,016** | 248,972 |
| Loans, net of unearned income | **20,600,935** | 16,427,673 |
| Allowance for loan losses | **189,705** | 158,159 |
| Total net loans | **$20,411,230** | $16,269,514 |

On December 31, 2005, $5.3 billion of real estate residential qualifying loans were pledged to secure potential Federal Home Loan Bank borrowings. Qualifying loans are comprised of residential mortgage loans secured by first and second liens and home equity lines of credit. In addition, $5.6 billion of commercial, financial and industrial loans were pledged to secure potential discount window borrowings from the Federal Reserve Bank.

Nonperforming loans consist of loans which management has identified as impaired, other nonaccrual loans and loans which have been restructured. On December 31, 2005 and 2004, there were no outstanding commitments to advance additional funds to customers whose loans had been restructured. The following table presents nonperforming loans on December 31:

| *(Dollars in thousands)* | **2005** | 2004 |
|---|---|---|
| Impaired loans | **$ 36,635** | $ 34,831 |
| Other nonaccrual loans* | **15,624** | 14,729 |
| Total nonperforming loans | **$ 52,259** | $ 49,560 |

* On December 31, 2005 and 2004, other nonaccrual loans included $11.5 million and $8.5 million, respectively, of loans held for sale.

Interest income received during 2005 for impaired loans was $.5 million and for other nonaccrual loans was $.1 million. Under their original terms, interest income would have been approximately $2.6 million for the impaired loans and $1.1 million for the other nonaccrual loans outstanding on December 31, 2005. Interest income received during 2004 for impaired loans was $.5 million and for other nonaccrual loans was $.1 million. Under their original terms, interest income would have been approximately $2.6 million for the impaired loans and $1.0 million for the other nonaccrual loans outstanding on December 31, 2004. Interest income received during 2003 for impaired loans was $.4 million and for other nonaccrual loans was $14,000. Under their original terms, interest income would have been approximately $2.9 million for the impaired loans and $.7 million for the other nonaccrual loans outstanding on December 31, 2003. The average balance of impaired loans was approximately $36.3 million for 2005, $36.9 million for 2004 and $45.4 million for 2003. All impaired loans have an associated allowance for loan loss.

### Note 4 ❑ Loans (continued)

Activity in the allowance for loan losses related to non-impaired and impaired loans for years ended December 31 is summarized as follows:

| *(Dollars in thousands)* | Non-impaired | Impaired | Total |
|---|---|---|---|
| Balance on December 31, 2002 | $ 129,229 | $ 15,069 | $ 144,298 |
| Adjustment due to divestiture | (2,652) | - | (2,652) |
| Provision for loan losses | 73,249 | 13,449 | 86,698 |
| Charge-offs | (63,113) | (19,323) | (82,436) |
| Recoveries | 12,440 | 1,985 | 14,425 |
| Net charge-offs | (50,673) | (17,338) | (68,011) |
| Balance on December 31, 2003 | 149,153 | 11,180 | 160,333 |
| Loans transferred to held for sale | (8,382) | - | (8,382) |
| Provision for loan losses | 40,402 | 7,946 | 48,348 |
| Charge-offs | (45,772) | (10,857) | (56,629) |
| Recoveries | 12,271 | 2,218 | 14,489 |
| Net charge-offs | (33,501) | (8,639) | (42,140) |
| Balance on December 31, 2004 | 147,672 | 10,487 | 158,159 |
| Allowance from acquisitions | 1,902 | - | 1,902 |
| Adjustment due to divestiture | (516) | - | (516) |
| Provision for loan losses | 61,799 | 5,879 | 67,678 |
| Charge-offs | (41,963) | (10,187) | (52,150) |
| Recoveries | 10,741 | 3,891 | 14,632 |
| Net charge-offs | (31,222) | (6,296) | (37,518) |
| **Balance on December 31, 2005** | **$179,635** | **$10,070** | **$189,705** |

Included in other assets and in other liabilities on the Consolidated Statements of Condition are amounts due from customers on acceptances and bank acceptances outstanding of $5.3 million and $9.2 million on December 31, 2005 and 2004, respectively. In 2005, FHN transferred approximately $.3 billion of real estate residential loans from held for sale into the loan portfolio. In 2004, FHN transferred approximately $1.6 billion of real estate residential loans to held for sale.

## Note 5 ❑ Premises, Equipment and Leases

Premises and equipment on December 31 are summarized below:

| *(Dollars in thousands)* | **2005** | 2004 |
|---|---|---|
| Land | **$ 58,210** | $ 51,253 |
| Buildings | **293,582** | 267,362 |
| Leasehold improvements | **77,493** | 58,999 |
| Furniture, fixtures and equipment | **331,411** | 316,082 |
| Premises and equipment, at cost | **760,696** | 693,696 |
| Less accumulated depreciation and amortization | **345,716** | 314,337 |
| Premises and equipment, net | **$414,980** | $379,359 |

FHN is obligated under a number of noncancelable operating leases for premises and equipment with terms up to 30 years, which may include the payment of taxes, insurance and maintenance costs.

Minimum future lease payments for noncancelable operating leases on premises and equipment on December 31, 2005, are shown below:

| *(Dollars in thousands)* | |
|---|---|
| 2006 | $ 70,757 |
| 2007 | 60,109 |
| 2008 | 42,408 |
| 2009 | 26,539 |
| 2010 | 17,936 |
| 2011 and after | 47,062 |
| Total minimum lease payments | $264,811 |

Payments required under capital leases are not material.

Aggregate minimum income under sublease agreements for these periods is $5.4 million.

Rent expense incurred under all operating lease obligations was as follows for the years ended December 31:

| *(Dollars in thousands)* | **2005** | 2004 | 2003 |
|---|---|---|---|
| Rent expense, gross | **$84,609** | $69,581 | $64,260 |
| Sublease income | **(3,158)** | (3,217) | (4,543) |
| Rent expense, net | **$81,451** | $66,364 | $59,717 |

### Note 6 ❑ Mortgage Servicing Rights

Following is a summary of changes in capitalized MSR, net of accumulated amortization and valuation allowance, included in the Consolidated Statements of Condition:

*(Dollars in thousands)*

| | |
|---|---|
| December 31, 2002 | $ 440,482 |
| Addition of mortgage servicing rights | 536,655 |
| Amortization | (132,273) |
| Market value adjustments | 115,673 |
| Sales of mortgage servicing rights | (6,275) |
| Permanent impairment | (155,586) |
| Increase in valuation allowance | (2,738) |
| December 31, 2003 | 795,938 |
| Addition of mortgage servicing rights | 450,826 |
| Amortization | (154,301) |
| Market value adjustments | (18,943) |
| Permanent impairment | (69,299) |
| Decrease in valuation allowance | 32,237 |
| December 31, 2004 | 1,036,458 |
| Addition of mortgage servicing rights | 437,121 |
| Amortization | (194,800) |
| Market value adjustments | 71,094 |
| Permanent impairment | (38,239) |
| Decrease in valuation allowance | 2,995 |
| **December 31, 2005** | **$1,314,629** |

MSR on December 31, 2005, 2004 and 2003 had estimated market values of approximately $1,334.5 million, $1,049.7 million and $838.5 million, respectively. These balances represent the rights to service approximately $93.7 billion, $83.6 billion and $65.1 billion of mortgage loans on December 31, 2005, 2004 and 2003, respectively, for which a servicing right has been capitalized. The following is a rollforward of the valuation allowance required due to temporary impairment as of December 31, 2005, 2004 and 2003:

*(Dollars in thousands)*

| | |
|---|---|
| Balance on December 31, 2002 | $ 33,730 |
| Permanent impairment | (155,586) |
| Servicing valuation provision | 158,324 |
| Balance on December 31, 2003 | 36,468 |
| Permanent impairment | (69,299) |
| Servicing valuation provision | 37,062 |
| Balance on December 31, 2004 | 4,231 |
| Permanent impairment | (38,239) |
| Servicing valuation provision | 35,244 |
| **Balance on December 31, 2005** | **$ 1,236** |

## Note 6 ❑ Mortgage Servicing Rights (continued)

Estimated MSR amortization expense for the years ending 2006, 2007, 2008, 2009 and 2010 are $187.7 million, $162.7 million, $140.5 million, $121.4 million, and $103.3 million, respectively. The assumptions underlying these estimates are subject to modification based on changes in market conditions and portfolio behavior (such as prepayment speeds). As a result, these estimates are subject to change in a manner and amount that is not presently determinable by management.

For purposes of impairment evaluation and measurement, the MSR are stratified based on the predominant risk characteristics of the underlying loans. These strata currently include adjustable- and fixed-rate loans and geographic risk characteristics. The MSR are amortized over the period of and in proportion to the estimated net servicing revenues. A quarterly impairment analysis is performed using a discounted cash flow methodology that is disaggregated by predominant risk characteristics. Impairment, if any, is recognized through a valuation allowance for individual strata. However, if the impairment is determined to be other-than-temporary, a direct write-off of the asset is made.

## Note 7 ❑ Intangible Assets

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

| *(Dollars in thousands)* | Goodwill | Other Intangible Assets* |
|---|---|---|
| December 31, 2002 | $164,617 | $ 29,648 |
| Amortization expense | - | (7,980) |
| Minimum pension liability adjustment | - | (89) |
| Divestitures | (13,303) | (1,632) |
| Acquisitions** | 23,493 | 18,795 |
| December 31, 2003 | 174,807 | 38,742 |
| Amortization expense | - | (9,541) |
| Minimum pension liability adjustment | - | (129) |
| Divestitures | (810) | (359) |
| Acquisitions** | 13,203 | 6,056 |
| December 31, 2004 | 187,200 | 34,769 |
| Amortization expense | - | (13,734) |
| Minimum pension liability adjustment | - | 1,555 |
| Divestitures | - | (633) |
| Acquisitions** | 121,588 | 63,906 |
| **December 31, 2005** | **$308,788** | **$ 85,863** |

* 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.

## Note 7 ❑ Intangible Assets (continued)

The gross carrying amount of other intangible assets subject to amortization is $159.6 million on December 31, 2005, net of $73.7 million of accumulated amortization. Estimated aggregate amortization expense is expected to be $12.6 million, $11.6 million, $9.7 million, $8.0 million, and $6.7 million for 2006, 2007, 2008, 2009 and 2010, respectively.

The following is a summary of goodwill detailed by reportable segments for the three years ended December 31, 2005:

| *(Dollars in thousands)* | Retail/ Commercial Banking | Mortgage Banking | Capital Markets | Total |
|---|---|---|---|---|
| December 31, 2002 | $ 98,945 | $ 52,378 | $ 13,294 | $ 164,617 |
| Divestitures | (13,303) | - | - | (13,303) |
| Acquisitions* | 23,883 | (390) | - | 23,493 |
| December 31, 2003 | 109,525 | 51,988 | 13,294 | 174,807 |
| Divestitures | (810) | - | - | (810) |
| Acquisitions* | 5,626 | 3,226 | 4,351 | 13,203 |
| December 31, 2004 | 114,341 | 55,214 | 17,645 | 187,200 |
| Acquisitions* | 17,788 | 6,379 | 97,421 | 121,588 |
| **December 31, 2005** | **$132,129** | **$61,593** | **$115,066** | **$308,788** |

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

## Note 8 ❑ Time Deposit Maturities

Following is a table of maturities for time deposits outstanding on December 31, 2005, which include “Certificates of deposit under $100,000 and other time” and “Certificates of deposit $100,000 and more”. “Certificates of deposit $100,000 and more” totaled $10.9 billion on December 31, 2005. Time deposits are included in “Interest-bearing” deposits on the Consolidated Statements of Condition.

| *(Dollars in thousands)* | |
|---|---|
| 2006 | $11,937,607 |
| 2007 | 631,547 |
| 2008 | 286,323 |
| 2009 | 139,815 |
| 2010 | 115,743 |
| 2011 and after | 299,606 |
| Total | $13,410,641 |

## Note 9 ❑ Short-Term Borrowings

Short-term borrowings include federal funds purchased and securities sold under agreements to repurchase, commercial paper, trading liabilities and other borrowed funds.

Federal funds purchased and securities sold under agreements to repurchase and commercial paper generally have maturities of less than 90 days. Trading liabilities, which include short positions in securities, are generally held for less than 90 days. Other short-term borrowings have original maturities of one year or less. On December 31, 2005, capital markets trading securities with a fair value of $731.8 million were pledged to secure other short-term borrowings.

## Note 9 ❑ Short-Term Borrowings (continued)

The detail of these borrowings for the years 2005, 2004 and 2003 is presented in the following table:

| *(Dollars in thousands)* | Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | Commercial Paper | Trading Liabilities | Other Short-term Borrowings |
|---|---|---|---|---|
| **2005** | | | | |
| Average balance | **$4,582,178** | **$ 7,001** | **$1,519,337** | **$ 987,771** |
| Year-end balance | **3,735,742** | **10,695** | **793,638** | **791,322** |
| Maximum month-end outstanding | **5,458,983** | **26,466** | **1,663,319** | **1,339,531** |
| Average rate for the year | **2.98%** | **1.50%** | **5.28%** | **3.57%** |
| Average rate at year-end | **3.51** | **1.98** | **5.97** | **3.84** |
| 2004 | | | | |
| Average balance | $ 3,685,153 | $ 20,385 | $ 527,032 | $ 116,269 |
| Year-end balance | 3,247,048 | 23,712 | 426,343 | 116,064 |
| Maximum month-end outstanding | 4,387,946 | 30,885 | 900,233 | 189,683 |
| Average rate for the year | 1.22% | .89% | 3.80% | 2.14% |
| Average rate at year-end | 1.87 | 1.18 | 3.52 | 1.37 |
| 2003 | | | | |
| Average balance | $ 3,712,768 | $ 20,902 | $ 547,071 | $ 130,189 |
| Year-end balance | 3,079,248 | 31,793 | 127,717 | 102,418 |
| Maximum month-end outstanding | 4,703,454 | 31,793 | 981,736 | 237,908 |
| Average rate for the year | .99% | .93% | 4.04% | 2.25% |
| Average rate at year-end | .79 | .78 | 5.47 | .98 |

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

On December 31, 2005, $50 million of borrowings under unsecured lines of credit from non-affiliated banks were available to the parent company to provide for general liquidity needs at an annual facility fee of .10 percent.

## Note 10 ❑ Term Borrowings

The following table presents information pertaining to term borrowings (debt with original maturities greater than one year) for FHN and its subsidiaries on December 31:

| *(Dollars in thousands)* | **2005** | 2004 |
|---|---|---|
| **First Tennessee Bank National Association:** | | |
| Subordinated notes (qualifies for total capital under the Risk-Based Capital guidelines): | | |
| Matures on January 15, 2015 – 5.05% | **$ 392,279** | $ 400,872 |
| Matures on May 15, 2013 – 4.625% | **251,135** | 258,837 |
| Matures on December 1, 2008 – 5.75% | **136,847** | 140,402 |
| Matures on April 1, 2008 – 6.40% | **89,841** | 89,771 |
| Bank notes* | **874,672** | 1,249,950 |
| Extendible notes** | | |
| Final maturity of November 17, 2010 – 4.36% | **1,249,110** | - |
| Federal Home Loan Bank borrowings*** | **4,381** | 4,717 |
| Other**** | **-** | 1,259 |
| **First Horizon National Corporation:** | | |
| Subordinated capital notes (qualifies for total capital under the Risk-Based Capital guidelines): | | |
| Matures on May 15, 2013 – 4.50% | **100,478** | 103,601 |
| Matured on November 15, 2005 – 6.75% | **-** | 22,875 |
| Subordinated notes (Note 11): | | |
| Matures on January 6, 2027 – 8.07% | **99,737** | 101,064 |
| Matures on April 15, 2034 – 6.30% | **193,878** | 197,803 |
| **FT Real Estate Securities Company, Inc.** | | |
| Cumulative preferred stock (qualifies for total capital under the Risk-Based Capital guidelines) (Note 12): | | |
| Matures on March 31, 2031 – 9.50% | **45,285** | 45,217 |
| Total | **$3,437,643** | $ 2,616,368 |

* The bank notes were issued with variable interest rates and have remaining terms of 1 to 3 years. These bank notes had weighted average interest rates of 4.66 percent and 2.35 percent on December 31, 2005 and 2004, respectively.

** As of December 31, 2005, the extendible notes had a contractual maturity of January 17, 2007, but are extendible at the investors' option to the final maturity date of November 17, 2010.

*** The Federal Home Loan Bank (FHLB) borrowings were issued with fixed interest rates and have remaining terms of 4 to 24 years. These borrowings had weighted average interest rates of 3.40 percent and 3.57 percent on December 31, 2005 and 2004, respectively.

**** Other long-term debt was comprised of unsecured obligations issued with fixed interest rates and had a weighted average interest rate of 5.00 percent on December 31, 2004.

Annual principal repayment requirements as of December 31, 2005, are as follows:

| *(Dollars in thousands)* | |
|---|---|
| 2006 | $ 350,338 |
| 2007 | 1,400,338 |
| 2008 | 606,963 |
| 2009 | 321 |
| 2010 | 137 |
| 2011 and after | 1,109,187 |

All subordinated notes are unsecured and are subordinate to other present and future senior indebtedness. FTBNA's subordinated notes and FHN's subordinated capital notes qualify as Tier 2 risk-based capital under the Office of the Comptroller of the Currency and Federal Reserve Board guidelines for assessing capital adequacy. Prior to February 2005, FTBNA had a bank note program

### Note 10 ❑ Term Borrowings (continued)

under which the bank was able to borrow funds from time to time at maturities of 30 days to 30 years. This bank note program was terminated in connection with the establishment of a new program. That termination did not affect any previously issued notes outstanding. In February 2005, FTBNA established a new bank note program providing additional liquidity of $5.0 billion. This bank note program provides FTBNA with a facility under which it may continuously issue and offer short- and medium-term unsecured notes. On December 31, 2005, $4.3 billion was available under current conditions through the bank note program.

In November 2005, FTBNA entered into a $3.0 billion floating rate extendible note program. The extendible note program provides FTBNA with a facility under which it may issue and offer unsecured and unsubordinated notes with initial maturities of thirteen months and final maturities of five years. On December 31, 2005, $1.7 billion was available under current conditions through the extendible note program.

### Note 11 ❑ Guaranteed Preferred Beneficial Interests in First Horizon's Junior Subordinated Debentures

On December 30, 1996, FHN, through its underwriter, sold $100 million of capital securities. First Tennessee Capital I (Capital I), a Delaware business trust wholly owned by FHN, issued $100 million of Capital Securities, Series A at 8.07 percent. The proceeds were loaned to FHN as junior subordinated debt. FHN has, through various contractual arrangements, fully and unconditionally guaranteed all of Capital I's obligations with respect to the capital securities. The sole asset of Capital I is $103 million of junior subordinated debentures issued by FHN. These junior subordinated debentures also carry an interest rate of 8.07 percent. Both the capital securities of Capital I and the junior subordinated debentures of FHN will mature on January 6, 2027; however, under certain circumstances, the maturity of both may be shortened to a date not earlier than January 6, 2017. The capital securities qualify as Tier 1 capital. The junior subordinated debentures are included in the Consolidated Statements of Condition in "Term borrowings" (see Note 10—Term Borrowings).

On March 29, 2004, FHN, through its underwriter, sold $200 million of capital securities. First Tennessee Capital II (Capital II), a Delaware business trust wholly owned by FHN, issued $200 million of Capital Securities, Series B at 6.30 percent. The proceeds were loaned to FHN as junior subordinated debt. FHN has, through various contractual arrangements, fully and unconditionally guaranteed all of Capital II's obligations with respect to the capital securities. The sole asset of Capital II is $206 million of junior subordinated debentures issued by FHN. These junior subordinated debentures also carry an interest rate of 6.30 percent. Both the capital securities of Capital II and the junior subordinated debentures of FHN will mature on April 15, 2034, however, under certain circumstances, the maturity of both may be shortened to a date not earlier than April 15, 2009. The capital securities qualify as Tier 1 capital. The junior subordinated debentures are included in the Consolidated Statements of Condition in "Term borrowings" (see Note 10—Term Borrowings).

### Note 12 ❑ Preferred Stock of Subsidiary

On September 14, 2000, FT Real Estate Securities Company, Inc. (FTRESC), an indirect subsidiary of FHN, issued 50 shares of 9.50% Cumulative Preferred Stock, Class B (Class B Preferred Shares), with a liquidation preference of $1.0 million per share. An aggregate total of 47 Class B Preferred Shares have been sold privately to nonaffiliates. These securities qualify as Tier 2 capital and are presented in the Consolidated Statements of Condition as "Term borrowings". FTRESC is a real estate investment trust (REIT) established for the purpose of acquiring, holding and managing real estate mortgage assets. Dividends on the Class B Preferred Shares are cumulative and are payable semi-annually.

## Note 12 ❑ Preferred Stock of Subsidiary (continued)

The Class B Preferred Shares are mandatorily redeemable on March 31, 2031, and redeemable at the discretion of FTRESC in the event that the Class B Preferred Shares cannot be accounted for as Tier 2 regulatory capital or there is more than an insubstantial risk that dividends paid with respect to the Class B Preferred Shares will not be fully deductible for tax purposes. They are not subject to any sinking fund and are not convertible into any other securities of FTRESC, FHN or any of its subsidiaries. The shares are, however, automatically exchanged at the direction of the Office of the Comptroller of the Currency for preferred stock of FTBNA, having substantially the same terms as the Class B Preferred Shares in the event FTBNA becomes undercapitalized, insolvent or in danger of becoming undercapitalized.

On July 1, 2003, FHN adopted certain provisions of SFAS No. 150, which requires certain financial instruments with both liability and equity characteristics to be classified as liabilities on the statement of condition. Upon adoption of this statement, FHN classified its mandatorily redeemable preferred stock of subsidiary in "Term borrowings" (See Note 10 – Term Borrowings). Historically, the related distributions on these instruments ($4.6 million annually) were classified as noninterest expense on the Consolidated Statements of Income, but as of July 1, 2003, are classified as interest expense on a prospective basis. Restatement of prior periods was not permitted.

The following indirect, wholly-owned subsidiaries of FHN have also issued preferred stock. First Horizon Mortgage Loan Corporation has issued $1.0 million of Class B Preferred Shares. Additionally, FHRIII, LLC and FHRIV, LLC have each issued $1.0 million of Class B Preferred Units. On December 31, 2005 and 2004, $.5 million of Class B Preferred Shares and Units that are perpetual in nature and not subject to the provisions of SFAS No. 150 was recognized as "Preferred stock of subsidiary" on the Consolidated Statements of Condition. The remaining balance has been eliminated in consolidation.

On March 23, 2005, FTBNA issued 300,000 shares of Class A Non-Cumulative Perpetual Preferred Stock (Class A Preferred Stock) with a liquidation preference of $1,000 per share. These securities qualify as Tier 1 capital. On December 31, 2005, $294.8 million of Class A Preferred Stock was recognized as "Preferred stock of subsidiary" on the Consolidated Statements of Condition.

## Note 13 ❑ Regulatory Capital

FHN is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on FHN's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, specific capital guidelines that involve quantitative measures of assets, liabilities and certain derivatives as calculated under regulatory accounting practices must be met. Capital amounts and classification are also subject to qualitative judgment by the regulators about components, risk weightings and other factors. Quantitative measures established by regulation to ensure capital adequacy require FHN to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets (leverage). Management believes, as of December 31, 2005, 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 11.26 percent, 8.18 percent and 6.67 percent, respectively, on December 31, 2005, and were 12.37 percent, 8.41 percent and 7.04 percent, respectively, on December 31, 2004.

## Note 13 ❑ Regulatory Capital (continued)

| | First Horizon National Corporation | | First Tennessee Bank National Association | |
|---|---|---|---|---|
| *(Dollars in thousands)* | Amount | Ratio | Amount | Ratio |
| **On December 31, 2005:** | | | | |
| Actual: | | | | |
| Total Capital | $ 3,579,489 | 12.30% | $ 3,441,714 | 11.61% |
| Tier 1 Capital | 2,489,026 | 8.55 | 2,451,252 | 8.27 |
| Leverage | 2,489,026 | 6.67 | 2,451,252 | 6.62 |
| For Capital Adequacy Purposes: | | | | |
| Total Capital | 2,328,950 ≥ | 8.00 | 2,370,729 ≥ | 8.00 |
| Tier 1 Capital | 1,164,475 ≥ | 4.00 | 1,185,364 ≥ | 4.00 |
| Leverage | 1,493,291 ≥ | 4.00 | 1,482,214 ≥ | 4.00 |
| To Be Well Capitalized Under Prompt Corrective Action Provisions: | | | | |
| Total Capital | | | 2,963,411 ≥ | 10.00 |
| Tier 1 Capital | | | 1,778,047 ≥ | 6.00 |
| Leverage | | | 1,852,767 ≥ | 5.00 |
| On December 31, 2004: | | | | |
| Actual: | | | | |
| Total Capital | $ 3,182,733 | 13.18% | $ 3,064,060 | 12.79% |
| Tier 1 Capital | 2,080,237 | 8.62 | 2,061,564 | 8.61 |
| Leverage | 2,080,237 | 7.16 | 2,061,564 | 7.15 |
| For Capital Adequacy Purposes: | | | | |
| Total Capital | 1,931,256 ≥ | 8.00 | 1,916,456 ≥ | 8.00 |
| Tier 1 Capital | 965,628 ≥ | 4.00 | 958,228 ≥ | 4.00 |
| Leverage | 1,162,155 ≥ | 4.00 | 1,152,831 ≥ | 4.00 |
| To Be Well Capitalized Under Prompt Corrective Action Provisions: | | | | |
| Total Capital | | | 2,395,570 ≥ | 10.00 |
| Tier 1 Capital | | | 1,437,342 ≥ | 6.00 |
| Leverage | | | 1,441,039 ≥ | 5.00 |

## Note 14 ❑ Other Income and Other Expense

Following is detail concerning “All other income” and “All other expense” as presented in the Consolidated Statements of Income:

| *(Dollars in thousands)* | **2005** | 2004 | 2003 |
|---|---|---|---|
| **All other income:** | | | |
| Cardholder fees | **$ 27,381** | $ 25,075 | $ 22,698 |
| Other service charges | **22,470** | 19,709 | 19,810 |
| Remittance processing | **15,411** | 19,515 | 23,666 |
| Check clearing fees | **7,333** | 10,052 | 11,839 |
| Other | **93,704** | 89,673 | 68,286 |
| Total | **$166,299** | $164,024 | $146,299 |
| **All other expense:** | | | |
| Advertising and public relations | **$ 46,389** | $ 39,961 | $ 43,955 |
| Legal and professional fees | **45,239** | 37,730 | 60,001 |
| Computer software | **32,654** | 28,906 | 28,828 |
| Travel and entertainment | **32,126** | 30,794 | 37,432 |
| Contract employment | **31,062** | 23,714 | 33,790 |
| Supplies | **17,636** | 17,591 | 18,783 |
| Fed service fees | **7,568** | 8,838 | 9,195 |
| Foreclosed real estate | **7,265** | 5,834 | 13,137 |
| Deposit insurance premium | **3,012** | 3,024 | 2,703 |
| Contributions | **2,203** | 1,497 | 13,370 |
| Distributions on guaranteed preferred securities | **—** | — | 8,070 |
| Distributions on preferred stock of subsidiary | **10,757** | — | 2,282 |
| Other | **104,295** | 102,753 | 121,498 |
| Total | **$340,206** | $300,642 | $393,044 |

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

## Note 15 ❑ Components of Other Comprehensive (Loss)/Income

Following is detail of “Accumulated other comprehensive (loss)/income” as presented in the Consolidated Statements of Condition:

| *(Dollars in thousands)* | Before-Tax Amount | Tax (Expense)/ Benefit | Accumulated Other Comprehensive (Loss)/Income |
|---|---|---|---|
| December 31, 2002 | | | $ 26,487 |
| Other comprehensive income: | | | |
| Unrealized market adjustments on cash flow hedge | $ 224 | $ (87) | 137 |
| Minimum pension liability | (1,786) | 657 | (1,129) |
| Unrealized market adjustments on securities available for sale | (37,988) | 14,637 | (23,351) |
| Adjustment for net gains included in net income | (2,378) | 916 | (1,462) |
| December 31, 2003 | $ (41,928) | $ 16,123 | 682 |
| Other comprehensive income: | | | |
| Minimum pension liability | $ (505) | $ 186 | (319) |
| Unrealized market adjustments on securities available for sale | 3,961 | (1,533) | 2,428 |
| Adjustment for net gains included in net income | (20,748) | 8,029 | (12,719) |
| December 31, 2004 | $ (17,292) | $ 6,682 | (9,928) |
| Other comprehensive income: | | | |
| Unrealized market adjustments on cash flow hedge | $ (123) | $ 46 | (77) |
| Minimum pension liability | 215 | (79) | 136 |
| Unrealized market adjustments on securities available for sale | (53,562) | 20,834 | (32,728) |
| Adjustment for net gains included in net income | 578 | (225) | 353 |
| **December 31, 2005** | **$(52,892)** | **$20,576** | **$(42,244)** |

## Note 16 ❑ Income Taxes

The components of income tax expense/(benefit) are as follows:

| *(Dollars in thousands)* | **2005** | 2004 | 2003 |
|---|---|---|---|
| Current: | | | |
| Federal | **$159,860** | $ 169,158 | $134,793 |
| State | **8,629** | 1,771 | (2,820) |
| Deferred: | | | |
| Federal | **33,297** | 29,855 | 80,779 |
| State | **2,289** | 11,617 | 32,937 |
| Total | **$204,075** | $ 212,401 | $245,689 |

The effective tax rates for 2005, 2004 and 2003 were 31.63 percent, 31.85 percent and 34.17 percent, respectively. Income tax expense was different than the amounts computed by applying the statutory federal income tax rate to income before income taxes because of the following:

| *(Dollars in thousands)* | **2005** | 2004 | 2003 |
|---|---|---|---|
| Federal income tax rate | **35%** | 35% | 35% |
| Tax computed at statutory rate | **$225,811** | $ 233,383 | $251,649 |
| Increase/(decrease) resulting from: | | | |
| State income taxes | **7,096** | 8,702 | 19,582 |
| Tax credits | **(17,937)** | (17,201) | (14,703) |
| Other | **(10,895)** | (12,483) | (10,839) |
| Total | **$204,075** | $ 212,401 | $245,689 |

A deferred tax asset or liability is recognized for the tax consequences of temporary differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The tax consequence is calculated by applying enacted statutory tax rates, applicable to future years, to these temporary differences. Temporary differences which gave rise to deferred tax (assets)/liabilities on December 31, 2005 and 2004, were as follows:

| *(Dollars in thousands)* | **2005** | 2004 |
|---|---|---|
| **Deferred tax assets:** | | |
| Loss reserves | **$ (74,376)** | $ (67,307) |
| Employee benefits | **(46,041)** | (47,556) |
| Accrued expenses | **(7,439)** | (8,326) |
| Investments in debt and equity securities | **(31,530)** | (15,544) |
| Other | **(4,600)** | (3,565) |
| Gross deferred tax assets | **(163,986)** | (142,298) |
| **Deferred tax liabilities:** | | |
| Capitalized mortgage servicing rights | **392,087** | 348,258 |
| Asset securitizations | **8,861** | 24,943 |
| Depreciation and amortization | **45,604** | 33,803 |
| Federal Home Loan Bank stock | **13,494** | 12,265 |
| Deferred fees and expenses | **38,775** | 39,754 |
| Other intangible assets | **18,242** | 16,200 |
| Other | **12,277** | 17,063 |
| Gross deferred tax liabilities | **529,340** | 492,286 |
| Net deferred tax liabilities | **$365,354** | $ 349,988 |

The deferred tax assets above are net of an insignificant valuation allowance due to capital losses. Other than these capital losses, no valuation allowance related to deferred tax assets has been

## Note 16 ❑ Income Taxes (continued)

recorded on December 31, 2005 and 2004, as management believes it is more likely than not that the remaining deferred tax assets will be fully realized.

## Note 17 ❑ Earnings per Share

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

| *(In thousands, except per share data)* | **2005** | 2004 | 2003 |
|---|---|---|---|
| Income before cumulative effect of changes in accounting principle | **$441,098** | $ 454,408 | $473,309 |
| Cumulative effect of changes in accounting principle, net of tax | **(3,098)** | - | - |
| Net income | **$438,000** | $ 454,408 | $473,309 |
| Weighted average common shares | **125,475** | 124,730 | 126,765 |
| Effect of dilutive securities | **3,475** | 3,706 | 4,111 |
| Diluted average common shares | **128,950** | 128,436 | 130,876 |
| **Earnings per common share:** | | | |
| Income before cumulative effect of changes in accounting principle | **$ 3.52** | $ 3.64 | $ 3.73 |
| Cumulative effect of changes in accounting principle, net of tax | **(.03)** | - | - |
| Net income | **$ 3.49** | $ 3.64 | $ 3.73 |
| **Diluted earnings per common share:** | | | |
| Income before cumulative effect of changes in accounting principle | **$ 3.42** | $ 3.54 | $ 3.62 |
| Cumulative effect of changes in accounting principle, net of tax | **(.02)** | - | - |
| Net income | **$ 3.40** | $ 3.54 | $ 3.62 |

Outstanding stock options of 4,731, 2,808 and 1,257 with weighted average exercise prices of $43.30, $45.70 and $40.73 per share for the years ended December 31, 2005, 2004 and 2003, respectively, were not included in the computation of diluted earnings per share because such shares would have had an antidilutive effect on earnings per share.

## Note 18 ❑ Restrictions, Contingencies and Other Disclosures

***Restrictions on cash and due from banks.*** The commercial banking subsidiaries of FHN are required to maintain average reserve and clearing balances with the Federal Reserve Bank under the Federal Reserve Act and Regulation D. The balances required on December 31, 2005 and 2004, were $265.5 million and $225.2 million, respectively. These reserves are included in “Cash and due from banks” on the Consolidated Statements of Condition.

***Restrictions on dividends.*** Dividends are paid by FHN from its assets, which are mainly provided by dividends from its subsidiaries. Certain regulatory restrictions exist regarding the ability of FTBNA to transfer funds to FHN in the form of cash, dividends, loans or advances. As of December 31, 2005, FTBNA had undivided profits of $2,167.2 million of which $815.3 million was available for distribution to FHN as dividends without prior regulatory approval.

***Restrictions on intercompany transactions.*** Under Federal banking law, banking subsidiaries may not extend credit to the parent company in excess of 10 percent of the bank’s capital stock and surplus, as defined, or $338.0 million on December 31, 2005. The parent company had covered transactions of $47.9 million from FTBNA on December 31, 2005. In addition the aggregate amount of covered transactions with all affiliates, as defined, is limited to 20 percent of the bank’s capital stock and surplus, or $676.0 million on December 31, 2005. FTBNA’s total covered transactions with all affiliates on December 31, 2005 were $238.7 million. Certain loan agreements also define other restricted transactions related to additional borrowings.

**Note 18 ❑ Restrictions, Contingencies and Other Disclosures (continued)**

***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 has been able to form an opinion on the effect all of these lawsuits, except the matter mentioned in the paragraph below, will have on the consolidated financial statements. It is management's opinion that when resolved, these lawsuits will not have a material adverse effect on the consolidated financial statements of FHN.

In November 2000, a complaint was filed in state court in Jackson County, Missouri against FHN's subsidiary, First Horizon Home Loans. The case generally concerns the charging of certain loan origination fees, including fees permitted by Kansas law but allegedly restricted or not permitted by Missouri law, when First Horizon Home Loans or its predecessor, McGuire Mortgage Company, made certain second-lien mortgage loans. Among other relief, plaintiffs seek a refund of fees, a repayment and forgiveness of loan interest, prejudgment interest, punitive damages, and loan rescission. In response to pre-trial motions, the court has ruled that Missouri law governs the loan transactions and has certified a statewide class action; plaintiffs contend the class involves approximately 4,800 loans, but the exact size is in dispute. Discovery is ongoing and additional pre-trial motions are pending. Trial is currently scheduled for May 2006. FHN believes that it has meritorious defenses and it intends to continue to protect its rights and defend this lawsuit vigorously, through trial and appeal, if necessary.

***Other disclosures—Company Owned Life Insurance.*** FHN has purchased life insurance on certain of its employees and is the beneficiary on these policies. On December 31, 2005, the cash surrender value of these policies, which is included in "Other assets" on the Consolidated Statements of Condition, was $502.3 million. There are restrictions on $67.0 million of the proceeds from these benefits which relate to certain compensation plans. FHN has not borrowed against the cash surrender value of these policies.

***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 representation 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 first-lien mortgage loan portfolio of approximately $95.3 billion as of December 31, 2005, 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. See Note 24–Securitizations for additional information on loans sold with recourse.

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

## Note 18 ❑ Restrictions, Contingencies and Other Disclosures (continued)

$16.4 million and $18.5 million as of December 31, 2005 and 2004, respectively. First Horizon Home Loans has sold certain mortgage loans with an agreement to repurchase the loans upon default. As of December 31, 2005 and 2004, First Horizon Home Loans had single-family residential loans with outstanding balances of $147.3 million and $186.8 million, respectively that were sold on a recourse basis. 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. As of December 31, 2005 and 2004, the outstanding principal balance of loans sold with limited recourse and serviced by First Horizon Home Loans was $3.2 billion and $3.4 billion, respectively.

FHN has securitized and sold home equity lines of credit and second-lien mortgages which are held by private security holders, and on December 31, 2005, the outstanding principal balance of these loans was $640.6 million and $142.7 million, respectively. On December 31, 2004, the outstanding principal balance of these loans was $1.3 billion and $229.3 million. 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 $57.0 million and $64.3 million on December 31, 2005 and 2004, 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.

## Note 19 ❑ Shareholder Protection Rights Agreement

On October 20, 1998, FHN adopted a Shareholder Protection Rights Agreement (the "Agreement") and declared a dividend of one right on each outstanding share of common stock held on November 2, 1998, or issued thereafter and prior to the time the rights separate and thereafter pursuant to options and convertible securities outstanding at the time the rights separate.

The Agreement provides that until the earlier of the tenth business day (subject to certain adjustments by the board of directors) after a person or group commences a tender or exchange offer that will, subject to certain exceptions, result in such person or group owning 10 percent or more of FHN's common stock, or the tenth business day (subject to certain adjustments by the board) after the public announcement by FHN that a person or group owns 10 percent or more of FHN's common stock, the rights will be evidenced by the common stock certificates, will automatically trade with the common stock, and will not be exercisable. Thereafter, separate rights certificates will be distributed, and each right will entitle its holder to purchase one one-hundredth of a share of participating preferred stock having economic and voting terms similar to those of one share of common stock for an exercise price of $150.

If any person or group acquires 10 percent or more of FHN's common stock, then each right (other than rights beneficially owned by holders of 10 percent or more of the common stock or affiliates, associates or transferees thereof, which rights become void) will entitle its holder to purchase, for the exercise price, a number of shares of FHN common stock or participating preferred stock having a market value of twice the exercise price. Also, if there is a 10 percent shareholder and FHN is involved in certain significant transactions, each right will entitle its holder to purchase, for the exercise price, a number of shares of common stock of the other party having a market value of twice the exercise price. If any person or group acquires 10 percent or more (but not more than 50 percent) of FHN's common stock, FHN's board of directors may, at its option, exchange one share of FHN common stock or one one-hundredth of a share of participating preferred stock for each right (other than rights which have become void). The board of directors may amend the Agreement in any respect prior to the tenth business day after announcement by FHN that a person or group has acquired 10 percent or more of FHN's common stock. The rights will expire on the earliest of the following times: the time of the exchange described in the second preceding sentence; December 31, 2009; or the date the rights are redeemed as described in the following sentence. The rights may be redeemed by the board of directors for $0.001 per right until 10 business days after FHN announces that any person or group owns 10 percent or more of FHN's common stock.

## Note 20 ❑ Savings, Pension and Other Employee Benefits

***Savings plan.*** Substantially all employees of FHN are covered by a contributory savings plan in conjunction with a flexible benefits plan. During the year, FHN makes contributions to each employee's flexible benefits plan account. These contributions are based on length of service and a percentage of the employee's salary. The employees have the option to direct a portion or all of the contribution into their savings plan accounts. Employees may also make pre-tax and after-tax personal contributions to the savings plan. FHN matches certain employee pre-tax contributions invested in FHN's common stock fund (or for employees of First Horizon Home Loans, contributions made to any savings plan fund) at a rate of $.50 for each $1.00 invested up to 6 percent of the employee's qualifying salary. Contributions made by FHN to the flexible benefits plan were $30.2 million for 2005, $26.8 million for 2004 and $24.4 million for 2003. A feature of the savings plan allows employees to choose to invest their savings in one or more of ten various component funds, including a nonleveraged employee stock ownership plan (ESOP). Compensation cost related to the ESOP is measured as the amount allocated from matching contributions and discretionary contributions contributed to the ESOP and is included in the contributions amount above. Dividends on shares held by the ESOP are charged to retained earnings and shares held by the ESOP are treated as outstanding in computing earnings per share. The number of allocated shares held by the ESOP totaled 8,262,203 on December 31, 2005.

***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(1)(17), which limit compensation to $210,000 for purposes of benefit calculations. Compensation is defined in the same manner as it is under the pension plan. Participants receive the difference between the monthly pension payable, if tax code limits did not apply, and the actual pension payable. All benefits provided under this plan are unfunded and payments to plan participants are made by FHN.

***Other employee benefits.*** FHN provides postretirement medical insurance to full-time employees retiring under the provisions of the FHN Pension Plan. The postretirement medical plan is contributory with retiree contributions adjusted annually. The plan is based on criteria that are a combination of the employee's age and years of service and utilizes a two-step approach. For any employee retiring on or after January 1, 1995, FHN contributes a fixed amount based on years of service and age at time of retirement. FHN's postretirement benefits include prescription drug benefits. The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) introduces a prescription drug benefit under Medicare Part D as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. On July 1, 2004, FHN adopted FSP FAS 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003". FSP FAS 106-2 requires a plan sponsor to determine if benefits offered through a postretirement health care plan are actuarially equivalent to Medicare Part D. Plan benefits were determined to be actuarially equivalent in 2005. Due to recognizing the Medicare Part D subsidy in 2005 the accumulated postretirement benefit obligation was reduced by $7.2 million and net periodic cost was reduced by $.4 million.

***Actuarial assumptions.*** To develop the expected long-term rate of return on assets assumption, FHN considered the current level of expected returns on risk free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. Since FHN's investment policy is to actively manage certain asset classes where the potential exists to outperform the broader market, the expected returns for those asset classes were adjusted to reflect the expected additional returns. The expected return for each asset class was then weighted based on the target asset allocation to develop the expected long-term rate of return on assets assumption for the portfolio. This resulted in the selection of an 8.65 percent assumption for 2006.

## Note 20 ❑ Savings, Pension and Other Employee Benefits (continued)

The discount rates for 2005 and 2004 for pension and postretirement benefits were determined by using a hypothetical AA yield curve represented by a series of annualized individual discount rates from one-half to thirty years. The discount rate is selected based on data specific to FHN's plans and employee population. For 2003, the discount rate was determined by monitoring Moody's AA corporate rates as of the measurement date to establish an annual discount rate. These rates were not based on FHN's specific participant data but were intended to be reflective of the interest rate at which pension liabilities could be settled. The rates as reflected by Moody's AA corporate rates were rounded to the nearest .25 percent.

The actuarial assumptions used in the defined benefit pension plan and the other employee benefit plan were as follows:

| | Pension Benefits | | | Postretirement Benefits | | |
|---|---|---|---|---|---|---|
| | **2005** | 2004 | 2003 | **2005** | 2004 | 2003 |
| **Weighted average assumptions used to determine benefit obligations as of September 30 measurement date** | | | | | | |
| Discount rate | **5.87%** | 6.47% | 6.25% | **5.64%** | 6.07% | 6.25% |
| Rate of compensation increase | **4.42** | 5.42 | 5.42 | **N/A** | N/A | N/A |
| **Weighted average assumptions used to determine net periodic benefit cost for the fiscal year** | | | | | | |
| Discount rate | **6.47%** | 6.25% | 6.75% | **6.00%** | 6.25% | 6.75% |
| Expected return on plan assets | **8.70** | 8.75 | 8.75 | **8.70** | 8.75 | 8.75 |
| Expected return on plan assets dedicated to employees who retired prior to January 1, 1993 | **N/A** | N/A | N/A | **5.70** | 5.75 | 5.75 |
| Rate of compensation increase | **5.42** | 5.42 | 4.54 | **N/A** | N/A | N/A |

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

The assumed health care cost trend rates used in the defined benefit pension plan and the other employee benefit plan were as follows:

| | **2005** | | 2004 | |
|---|---|---|---|---|
| **Assumed Health Care Cost Trend Rates on December 31** | **Participants under age 65** | **Participants 65 years and older** | Participants under age 65 | Participants 65 years and older |
| Health care cost trend rate assumed for next year | **10.0%** | **12.0%** | 9.0% | 11.0% |
| Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) | **6.0** | **6.0** | 6.0 | 8.0 |
| Year that the rate reaches the ultimate trend rate | **2013** | **2017** | 2010 | 2010 |

The health care cost trend rate assumption has a significant effect on the amounts reported. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

| *(Dollars in thousands)* | 1% Increase | 1% Decrease |
|---|---|---|
| Adjusted total service and interest cost components | $ 2,435 | $ 2,174 |
| Adjusted postretirement benefit obligation at end of plan year | 22,239 | 19,024 |

## Note 20 ❑ Savings, Pension and Other Employee Benefits (continued)

The components of net periodic benefit cost for the plan years 2005, 2004 and 2003 were as follows:

| | Pension Benefits | | | Postretirement Benefits | | |
|---|---|---|---|---|---|---|
| *(Dollars in thousands)* | **2005** | 2004 | 2003 | **2005** | 2004 | 2003 |
| **Components of net periodic benefit cost** | | | | | | |
| Service cost | **$15,781** | $14,359 | $12,832 | **$ 761** | $ 723 | $ 732 |
| Interest cost | **21,271** | 19,335 | 17,950 | **1,537** | 1,932 | 1,750 |
| Expected return on plan assets | **(33,835)** | (30,940) | (26,645) | **(1,670)** | (1,626) | (1,376) |
| Amortization of prior service cost | **827** | 684 | 736 | **(176)** | (176) | (176) |
| Recognized losses/(gain) | **4,055** | 3,711 | 637 | **(171)** | - | - |
| Amortization of transition (asset)/obligation | **-** | - | (20) | **989** | 989 | 989 |
| Net periodic cost | **$ 8,099** | $ 7,149 | $ 5,490 | **$1,270** | $1,842 | $1,919 |

The following table sets forth the plans' funded status reconciled to the amounts shown in the Consolidated Statements of Condition:

| | Pension Benefits | | Postretirement Benefits | |
|---|---|---|---|---|
| *(Dollars in thousands)* | **2005** | 2004 | **2005** | 2004 |
| **Change in benefit obligation** | | | | |
| Benefit obligation at beginning of plan year | **$333,408** | $ 312,357 | **$ 29,668** | $ 31,869 |
| Service cost | **15,781** | 14,359 | **761** | 723 |
| Interest cost | **21,271** | 19,335 | **1,537** | 1,932 |
| Amendments | **1,857** | - | **-** | - |
| Actuarial loss/(gain) | **18,902** | (1,174) | **(10,563)** | (3,257) |
| Benefits paid | **(11,449)** | (11,469) | **(850)** | (1,599) |
| Benefit obligation at end of plan year | **$379,770** | $ 333,408 | **$ 20,553** | $ 29,668 |
| **Change in plan assets** | | | | |
| Fair value of plan assets at beginning of plan year | **$348,065** | $ 288,059 | **$ 21,560** | $ 20,803 |
| Actual return on plan assets | **27,765** | 14,434 | **950** | 1,741 |
| Employer contribution | **37,558** | 57,041 | **-** | 615 |
| Benefits paid | **(11,449)** | (11,469) | **(850)** | (1,599) |
| Fair value of plan assets at end of plan year | **$401,939** | $ 348,065 | **$ 21,660** | $ 21,560 |
| **Net funded status on September 30** | **$ 22,169** | $ 14,657 | **$ 1,107** | $ (8,108) |
| Unrecognized net actuarial loss/(gain) | **130,681** | 109,765 | **(10,597)** | (925) |
| Unrecognized net transitional obligation | **-** | - | **6,917** | 7,906 |
| Unrecognized prior service cost/(benefit) | **6,791** | 5,760 | **(1,420)** | (1,596) |
| Prepaid benefit cost on September 30 | **159,641** | 130,182 | **(3,993)** | (2,723) |
| Contributions paid from October 1 to December 31 | **124** | 145 | **-** | - |
| Prepaid benefit cost on December 31 | **$159,765** | $ 130,327 | **$ (3,993)** | $ (2,723) |
| Amounts recognized in the Consolidated Statements of Condition consist of the following: | | | | |
| Prepaid benefit cost | **$159,765** | $ 130,327 | | |
| Accrued benefit liability | **(6,733)** | (5,393) | | |
| Intangible asset | **2,461** | 906 | | |
| Accumulated other comprehensive income | **4,272** | 4,487 | | |
| Net amount recognized | **$159,765** | $ 130,327 | | |

**Note 20 ❑ Savings, Pension and Other Employee Benefits (continued)**

The accumulated benefit obligation for the pension plan was $343.7 million and $284.7 million on September 30, 2005 and 2004, respectively. FHN expects to contribute the maximum tax deductible contribution to the pension plan, which is estimated to be approximately $20 million and expects to make no contribution to the other employee benefit plan in 2006. On September 30, 2005, the qualified pension plan had $168.9 million in prepaid benefit cost, while the supplemental executive retirement plan had $(9.3) million in benefit cost. The accrued benefit liability, intangible asset and accumulated other comprehensive income is attributable to the unfunded supplemental executive retirement plan.

The following table provides detail on expected benefit payments, which reflect expected future service, as appropriate, and projected Medicare reimbursements:

| *(Dollars in thousands)* | Pension Benefits | Postretirement Benefits | Medicare Reimbursements |
|---|---|---|---|
| 2006 | $ 11,206 | $ 1,629 | $ 420 |
| 2007 | 13,020 | 1,730 | 477 |
| 2008 | 14,538 | 1,813 | 543 |
| 2009 | 16,128 | 1,884 | 610 |
| 2010 | 17,778 | 1,952 | 672 |
| Years 2011 – 2015 | 118,805 | 10,297 | 2,474 |

The following provides the amount included within other comprehensive income for the period arising from a change in the minimum pension liability:

| | Pension Benefits | |
|---|---|---|
| *(Dollars in thousands)* | **2005** | 2004 |
| (Decrease)/increase in minimum pension liability included in other comprehensive income | **$(215)** | $505 |

The following table sets forth FHN's pension plan asset allocation on September 30, 2005 and 2004:

| | | | Percentage of Plan Assets on September 30 | | | |
|---|---|---|---|---|---|---|
| | Targeted Range | | **2005** | | 2004 | |
| Equity securities | 70% | | **69.7%** | | 68.1% | |
| Large capital equity | | 35% | | **31.7%** | | 39.0% |
| Small capital equity | | 20 | | **21.0** | | 19.2 |
| International equity | | 15 | | **17.0** | | 9.9 |
| Other | 30 | | **30.3** | | 31.9 | |
| Fixed income | | | | **29.3** | | 31.3 |
| Money market | | | | **1.0** | | .6 |
| Total | | | | **100.0%** | | 100.0% |

## Note 20 ❑ Savings, Pension and Other Employee Benefits (continued)

The primary investment objective is to ensure, over the long-term life of the pension plan, an adequate pool of sufficiently liquid assets to support the benefit obligations to participants, retirees and beneficiaries. In meeting this objective, the pension plan seeks to achieve a high level of investment return consistent with a prudent level of portfolio risk. Investment objectives are long-term in nature covering typical market cycles of three to five years. Any shortfall of investment performance compared to investment objectives should be explainable in terms of general economic and capital market conditions. In addition, the investment objective will be implemented through traditional long-term stock and bond strategies. It is not contemplated at this time that any derivative instruments will be used to achieve investment objectives.

During 2005 FHN reviewed its pension portfolio investment strategy and decided to maintain its equity exposure at 70 percent of total plan assets in 2006. The expected return on plan assets assumption for 2006 will be 8.65 percent.

Risk Management Practices: The asset allocation policy and the associated risk budget has been developed based on an evaluation of the organization's ability and willingness to assume investment risk in light of the Retirement Investment Committee's financial and benefits-related goals and objectives.

Frequency of Rebalancing: The Retirement Investment Committee will rebalance the portfolio assets as necessary to maintain liquidity for benefit payments and/or stay within the established target asset allocation ranges. At a minimum rebalancing will take place on an annual basis.

The following table sets forth FHN's other benefit plan asset allocation on September 30, 2005 and 2004:

| | Percentage of Plan Assets on September 30 | | | |
|---|---|---|---|---|
| | **2005** | | 2004 | |
| Equity securities | **56.6%** | | 55.5% | |
| Large capital equity | | **44.1%** | | 44.3% |
| Small capital equity | | **12.5** | | 11.2 |
| Other | **43.4** | | 44.5 | |
| Fixed income | | **42.1** | | 43.5 |
| Cash equivalents and money market | | **1.3** | | 1.0 |
| Total | | **100.0%** | | 100.0% |

The primary investment objective is to ensure, over the long-term life of the retiree medical obligation, an adequate pool of sufficiently liquid assets to partially support the obligations to retirees and beneficiaries. The allocation utilizing a tactical blend of individual securities and registered funds across the broad asset classes is designed to capture a reasonable balance of risk and return based on historical averages and parameters of Trust policy. In meeting this objective, the retiree medical plan seeks to achieve a high level of investment return consistent with a prudent level of portfolio risk. Investment objectives are long-term in nature (longer than 10 years). It is not contemplated at this time that any derivative instruments will be used to achieve investment objectives.

Tactical allocation within the broad strategic objective of 55/45 equity to fixed blend is contemplated periodically with an attention to the likelihood of improving the return potential coupled with a reduction of the risk level.

## Note 20 ❑ Savings, Pension and Other Employee Benefits (continued)

The following table sets forth the amounts of FHN common stock and amounts and types of mutual funds managed by FTBNA that are included in plan assets:

| | Pension Benefits | | Postretirement Benefits | |
|---|---|---|---|---|
| *(Dollars in thousands)* | **2005** | 2004 | **2005** | 2004 |
| First Funds Capital Appreciation Portfolio Class I | **$ 84,405** | $ 66,781 | **$2,728** | $2,423 |
| First Funds Core Equity Portfolio Class I | **103,165** | 106,722 | **7,204** | 7,106 |
| First Funds Intermediate Bond Portfolio Class I | **117,540** | 108,624 | **6,929** | 7,049 |
| First Funds U.S. Government Money Market Portfolio | **3,959** | - | **-** | - |
| First Horizon National Corporation Common Stock* | **24,002** | 28,631 | **-** | - |

* The number of shares of FHN common stock held by the pension plan was 660,300 on September 30, 2005 and September 30, 2004.

FHN plans to merge its First Funds family of funds with mutual funds managed by Goldman Sachs Asset Management. The merger is expected to be completed in the first quarter of 2006 pending fund shareholder and regulatory approvals.

FHN provides benefits to former and inactive employees after employment but before retirement. The obligation recognized was $2.3 million in 2005, $2.0 million in 2004 and $3.6 million in 2003.

Medical and group life insurance expenses incurred for active employees are shown in the following table:

| *(Dollars in thousands)* | **2005** | 2004 | 2003 |
|---|---|---|---|
| Medical plan expense based on claims incurred | **$35,068** | $27,312 | $23,919 |
| Participants | **9,591** | 9,130 | 8,576 |
| Group life insurance expense based on benefits incurred | **$ 2,476** | $ 2,992 | $ 2,171 |
| Participants | **13,466** | 12,709 | 11,653 |

## Note 21 ❑ Stock Option, Restricted Stock Incentive, and Dividend Reinvestment Plans

***Stock option plans.*** FHN issues non-qualified stock options under various plans to employees, non-employee directors, and bank advisory board members. The plans provide for the issuance of FHN common stock at a price equal to its fair market value at the date of grant. However, if the grantee agreed to receive the options in lieu of compensation, the exercise price was less than the fair market value. The foregone compensation plus the exercise price equaled the fair market value of the stock on the date of grant. This deferral program was discontinued in 2005, and any options issued below market on the date of grant during 2005 were related to 2004 salary deferrals for employees and 2004 board compensation for directors. All options vest within 3 to 5 years and expire 7 years or 10 years from the date of grant, except for those options that were previously part of compensation deferral, which vest immediately or after 6 months and expire 20 years from the date of grant. After January 2, 2004, stock options granted that are part of the compensation deferral vest immediately or after 6 months and expire 10 years from the date of grant. There were 1,344,980 shares available for option plan grants on December 31, 2005.

As a result of plan amendments adopted by the board of directors during 1997, employees have deferred the receipt of shares upon the exercise of stock options. Effective in 2005, no new deferral agreements are being executed. The summary of stock option activity is shown below:

| | Options Outstanding | Weighted Average Exercise Price |
|---|---|---|
| January 1, 2003 | 22,298,743 | $27.26 |
| Options granted | 3,931,673 | 36.80 |
| Options exercised* | (4,688,153) | 24.49 |
| Options canceled | (419,602) | 34.56 |
| December 31, 2003 | 21,122,661 | 29.51 |
| Options exercisable | 15,290,028 | 27.08 |
| January 1, 2004 | 21,122,661 | $29.51 |
| Options granted | 2,961,967 | 42.67 |
| Options exercised* | (2,829,981) | 25.24 |
| Options canceled | (822,413) | 37.85 |
| December 31, 2004 | 20,432,234 | 31.68 |
| Options exercisable | 13,690,108 | 27.82 |
| January 1, 2005 | 20,432,234 | $31.68 |
| Options granted | 2,401,011 | 39.76 |
| Options exercised* | (1,678,262) | 24.85 |
| Options canceled | (865,528) | 39.95 |
| **December 31, 2005** | **20,289,455** | **32.87** |
| Options exercisable | 13,187,630 | 28.63 |

* Stock options exercised for 2005, 2004 and 2003 respectively, included 14,346, 83,998 and 178,747 options converted to stock equivalents as part of the deferred compensation program.

## Note 21 ❑ Stock Option, Restricted Stock Incentive, and Dividend Reinvestment Plans (continued)

The following table summarizes information about stock options outstanding on December 31, 2005:

| Exercise Price Range | Options Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price-Options Outstanding | Options Exercisable | Weighted Average Exercise Price-Options Exercisable |
|---|---|---|---|---|---|
| $ 4.00 – $20.00 | 2,688,402 | 8.24 | $16.30 | 2,688,402 | $16.30 |
| $20.01 – $30.00 | 3,805,052 | 10.89 | 25.07 | 3,790,309 | 25.08 |
| $30.01 – $40.00 | 8,040,606 | 5.88 | 35.01 | 5,136,465 | 33.56 |
| $40.01 – $50.00 | 5,755,395 | 6.28 | 42.79 | 1,572,454 | 42.18 |

As FHN accounts for these stock option plans pursuant to APB Opinion No. 25, additional compensation cost would have been recognized in income under SFAS No. 123 for all stock-based compensation awards. Total additional compensation cost would have been $13.3 million for 2005, $13.9 million for 2004 and $32.9 million for 2003. See Note 1–Summary of Significant Accounting Policies for pro forma information.

FHN used the Black-Scholes Option Pricing Model to estimate the fair value of stock options granted in 2005, 2004 and 2003, with the following assumptions:

| | **2005** | 2004 | 2003 |
|---|---|---|---|
| Expected dividend yield | **4.26%** | 3.51% | 3.00% |
| Expected option lives of options issued at market | **5.11 years** | 4.93 years | 5.42 years |
| Expected option lives of options issued below market* | **5.34 years** | 4.54 years | 4.68 years |
| Expected volatility | **22.84%** | 26.57% | 30.63% |
| Risk-free interest rates | **3.89%** | 3.04% | 4.24% |

* Options are issued with an exercise price less than the fair market value on the date of grant if the grantee has agreed to receive the options in lieu of compensation. The foregone compensation plus the exercise price equals the fair market value on the date of grant.

| | Number Issued | Weighted Average Fair Value per Option at Grant Date |
|---|---|---|
| **2005:** | | |
| Options issued at market on the date of grant | **2,325,709** | **$ 6.42** |
| Options issued below market on the date of grant* | **75,302** | **21.73** |
| 2004: | | |
| Options issued at market on the date of grant | 2,608,368 | $ 8.61 |
| Options issued below market on the date of grant* | 353,599 | 22.42 |
| 2003: | | |
| Options issued at market on the date of grant | 3,258,924 | $ 8.52 |
| Options issued below market on the date of grant* | 672,749 | 20.19 |

* Options are issued with an exercise price less than the fair market value on the date of grant if the grantee has agreed to receive the options in lieu of compensation. The foregone compensation plus the exercise price equals the fair market value on the date of grant.

***Restricted stock incentive plans.*** FHN has authorized the issuance of its common stock for awards to executive employees who have a significant impact on the profitability of FHN under a performance accelerated restricted stock program. Additionally, one of the plans allows stock awards to be granted to non-employee directors upon approval by the board of directors. It has been the recent practice of the board to grant 8,000 shares of restricted stock to each new non-employee director upon election to the board, with restrictions lapsing at a rate of ten percent per year. In 2005, FHN granted 253,539 restricted shares under these programs. FHN granted 129,871 restricted stock awards to management employees which typically vest over 3 and 4 years. In addition, 533,837 performance stock units were granted to executive employees in 2005. The performance stock units will vest in 2008 only if predetermined performance measures are met. In 2004, 22,844 restricted shares were granted and 200,444 shares were granted in 2003. Compensation expense related to these plans was $9.1 million, $1.8 million and $5.1 million for the years 2005, 2004 and 2003, respectively.

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

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

## Note 22 ❑ 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, merchant services, check clearing, and correspondent services. 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, equity research and investment banking. The Corporate segment consists of unallocated corporate expenses, expense on subordinated debt issuances and preferred stock, bank-owned life insurance, unallocated interest income associated with excess equity, net impact of raising incremental capital, funds management and venture capital. In 2005, FHN adapted its segments to reflect changes in expense allocations between segments and the reclassification of certain trust preferred assets and related net interest income to the Capital Markets segment from Retail/Commercial Banking. 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 years ended December 31:

| *(Dollars in thousands)* | | **2005** | 2004 | 2003 |
|---|---|---|---|---|
| **Consolidated** | Net interest income | **$ 984,027** | $ 856,311 | $ 805,784 |
| | Provision for loan losses | **67,678** | 48,348 | 86,698 |
| | Noninterest income | **1,399,756** | 1,363,186 | 1,667,584 |
| | Noninterest expense | **1,670,932** | 1,504,340 | 1,667,672 |
| | Pre-tax income | **645,173** | 666,809 | 718,998 |
| | Provision for income taxes | **204,075** | 212,401 | 245,689 |
| | Income before cumulative effect of changes in accounting principle | **441,098** | 454,408 | 473,309 |
| | Cumulative effect of changes in accounting principle, net of tax | **(3,098)** | - | - |
| | Net income | **$ 438,000** | $ 454,408 | $ 473,309 |
| | Average assets | **$36,560,436** | $ 27,305,833 | $25,133,612 |
| | Depreciation, amortization and MSR impairment | **$ 386,194** | $ 324,585 | $ 425,231 |
| | Expenditures for long-lived assets | **95,661** | 78,763 | 149,600 |
| **Retail/Commercial Banking** | Net interest income | **$ 859,087** | $ 694,096 | $ 594,398 |
| | Provision for loan losses | **67,061** | 48,401 | 85,130 |
| | Noninterest income | **510,132** | 483,255 | 442,889 |
| | Noninterest expense | **827,077** | 736,388 | 717,826 |
| | Pre-tax income | **475,081** | 392,562 | 234,331 |
| | Provision for income taxes | **146,621** | 115,899 | 70,598 |
| | Income before cumulative effect of changes in accounting principle | **328,460** | 276,663 | 163,733 |
| | Cumulative effect of changes in accounting principle, net of tax | **(3,098)** | - | - |
| | Net income | **$ 325,362** | $ 276,663 | $ 163,733 |
| | Average assets | **$21,525,744** | $ 17,334,142 | $14,057,342 |
| | Depreciation, amortization and MSR impairment | **$ 106,751** | $ 93,527 | $ 82,206 |
| | Expenditures for long-lived assets | **68,290** | 45,660 | 59,290 |

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

## Note 22 ❑ Business Segment Information (continued)

| *(Dollars in thousands)* | | **2005** | 2004 | 2003 |
|---|---|---|---|---|
| **Mortgage Banking** | Net interest income | **$ 146,743** | $ 153,368 | $ 190,604 |
| | Provision for loan losses | **617** | (53) | 1,568 |
| | Noninterest income | **511,471** | 464,975 | 664,248 |
| | Noninterest expense | **465,992** | 423,238 | 457,552 |
| | Pre-tax income | **191,605** | 195,158 | 395,732 |
| | Provision for income taxes | **67,031** | 71,199 | 146,808 |
| | Net income | **$ 124,574** | $ 123,959 | $ 248,924 |
| | Average assets | **$6,318,409** | $ 5,295,512 | $6,441,890 |
| | Depreciation, amortization and MSR impairment | **$ 251,099** | $ 220,055 | $ 317,946 |
| | Expenditures for long-lived assets | **22,347** | 25,148 | 79,120 |
| **Capital Markets** | Net interest (expense)/ income | **$ (28,400)** | $ 5,452 | $ 8,062 |
| | Noninterest income | **367,704** | 383,690 | 545,787 |
| | Noninterest expense | **315,546** | 300,918 | 396,802 |
| | Pre-tax income | **23,758** | 88,224 | 157,047 |
| | Provision for income taxes | **8,023** | 32,817 | 58,722 |
| | Net income | **$ 15,735** | $ 55,407 | $ 98,325 |
| | Average assets | **$5,390,481** | $ 1,839,760 | $2,062,288 |
| | Depreciation and amortization | **$ 12,973** | $ 8,120 | $ 4,444 |
| | Expenditures for long-lived assets | **2,662** | 3,922 | 7,562 |
| **Corporate** | Net interest income | **$ 6,597** | $ 3,395 | $ 12,720 |
| | Noninterest income | **10,449** | 31,266 | 14,660 |
| | Noninterest expense | **62,317** | 43,796 | 95,492 |
| | Pre-tax loss | **(45,271)** | (9,135) | (68,112) |
| | Income tax benefit | **(17,600)** | (7,514) | (30,439) |
| | Net loss | **$ (27,671)** | $ (1,621) | $ (37,673) |
| | Average assets | **$3,325,802** | $ 2,836,419 | $2,572,092 |
| | Depreciation and amortization | **$ 15,371** | $ 2,883 | $ 20,635 |
| | Expenditures for long-lived assets | **2,362** | 4,033 | 3,628 |

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

## Note 23 ❑ Fair Value of Financial Instruments

Accounting standards require the disclosure of estimated fair values of all asset, liability and off-balance sheet financial instruments. The following fair value estimates are determined as of a specific point in time utilizing various assumptions and estimates. The use of assumptions and various valuation techniques, as well as the absence of secondary markets for certain financial instruments, will likely reduce the comparability of fair value disclosures between financial institutions. In some cases, book value is a reasonable estimate of fair value due to the relatively short period of time between origination of the instrument and its expected realization. The following table summarizes the book value and estimated fair value of financial instruments recorded in the Consolidated Statements of Condition as well as off-balance sheet commitments as of December 31, 2005 and 2004:

| | **December 31, 2005** | | December 31, 2004 | |
|---|---|---|---|---|
| | Book | Fair | Book | Fair |
| *(Dollars in thousands)* | Value | Value | Value | Value |
| **Assets:** | | | | |
| Loans, net of unearned income: | | | | |
| Floating | **$14,541,499** | **$14,540,403** | $11,821,969 | $11,821,652 |
| Fixed | **6,018,665** | **5,924,676** | 4,564,602 | 4,556,283 |
| Nonaccrual | **40,771** | **40,771** | 41,102 | 41,102 |
| Allowance for loan losses | **(189,705)** | **(189,705)** | (158,159) | (158,159) |
| Total net loans | **20,411,230** | **20,316,145** | 16,269,514 | 16,260,878 |
| Liquid assets | **3,629,314** | **3,629,314** | 1,675,654 | 1,675,654 |
| Loans held for sale | **4,435,343** | **4,450,081** | 5,167,981 | 5,194,866 |
| Securities available for sale | **2,912,103** | **2,912,103** | 2,680,556 | 2,680,556 |
| Securities held to maturity | **383** | **390** | 441 | 457 |
| Derivative assets | **49,259** | **49,259** | 134,451 | 134,451 |
| Nonearning assets | **1,608,700** | **1,608,700** | 1,007,215 | 1,007,215 |
| **Liabilities:** | | | | |
| Deposits: | | | | |
| Defined maturity | **$13,410,641** | **$13,405,293** | $10,277,438 | $10,311,409 |
| Undefined maturity | **10,027,129** | **10,027,129** | 9,504,729 | 9,504,729 |
| Total deposits | **23,437,770** | **23,432,422** | 19,782,167 | 19,816,138 |
| Short-term borrowings | **5,331,397** | **5,331,397** | 3,813,167 | 3,813,167 |
| Term borrowings | **3,437,643** | **3,465,705** | 2,616,368 | 2,647,367 |
| Derivative liabilities | **88,305** | **88,305** | 31,268 | 31,268 |
| Other noninterest-bearing liabilities | **696,558** | **696,558** | 444,924 | 444,924 |
| Preferred stock of subsidiary | **295,274** | **303,281** | 458 | 515 |
| | Contractual | Fair | Contractual | Fair |
| | Amount | Value | Amount | Value |
| **Off-Balance Sheet Commitments:** | | | | |
| Loan commitments | **$16,932,527** | **$9,735** | $13,622,394 | $11,010 |
| Other commitments | **771,604** | **8,439** | 703,214 | 8,962 |

The following describes the assumptions and methodologies used to estimate the fair value for financial instruments:

***Floating rate loans.*** With the exception of floating rate 1-4 family residential mortgage loans, the fair value is approximated by the book value. Floating rate 1-4 family residential mortgage loans reprice annually and will lag movements in market rates; whereas, commercial and consumer loans typically reprice monthly. The fair value for floating rate 1-4 family mortgage loans is calculated by discounting future cash flows to their present value. Future cash flows are discounted to their present value by using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same time period. Prepayment assumptions based on historical prepayment speeds and industry speeds for similar loans have been applied to the floating rate 1-4 family residential mortgage portfolio.

***Fixed rate loans.*** The fair value is estimated by discounting future cash flows to their present value. Future cash flows are discounted to their present value by using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same time period. Prepayment assumptions based on historical prepayment speeds and industry speeds for similar loans have been applied to the fixed rate mortgage and installment loan portfolios.

***Nonaccrual loans.*** The fair value is approximated by the book value.

***Allowance for loan losses.*** The fair value is approximated by the book value. Additionally, the credit exposure known to exist in the loan portfolio is embodied in the allowance for loan losses.

***Liquid assets.*** The fair value is approximated by the book value. For the purpose of this disclosure, liquid assets consist of federal funds sold, securities purchased under agreements to resell, capital markets securities inventory, mortgage banking trading securities, and investment in bank time deposits.

***Loans held for sale.*** Fair value of mortgage loans held for sale is based primarily on quoted market prices. Fair value of home equity lines of credit held for sale is based upon market values as evidenced in prior securitizations. Fair value of other loans held for sale is approximated by their carrying values.

***Securities available for sale.*** Fair values are based primarily on quoted market prices.

***Securities held to maturity.*** Fair values for marketable securities are based primarily on quoted market prices.

***Derivative assets.*** Fair values are based primarily on quoted market prices.

***Nonearning assets.*** The fair value is approximated by the book value. For the purpose of this disclosure, nonearning assets include cash and due from banks, accrued interest receivable and capital markets receivables.

***Defined maturity deposits.*** The fair value is estimated by discounting future cash flows to their present value. Future cash flows are discounted by using the current market rates of similar instruments applicable to the remaining maturity. For the purpose of this disclosure, defined maturity deposits include all certificates of deposit and other time deposits.

***Undefined maturity deposits.*** The fair value is approximated by the book value. For the purpose of this disclosure, undefined maturity deposits include demand deposits, checking interest accounts, savings accounts, and money market accounts.

***Short-term borrowings.*** The fair value of federal funds purchased, securities sold under agreements to repurchase, commercial paper, trading liabilities, and other short-term borrowings is approximated by the book value.

***Term borrowings.*** The fair value is approximated by the present value of the contractual cash flows discounted by the investor's yield which considers FHN's and FTBNA's debt ratings.

***Derivative liabilities.*** Fair values are based primarily on quoted market prices.

## Note 23 ❑ Fair Value of Financial Instruments (continued)

***Other noninterest-bearing liabilities.*** For the purpose of this disclosure, other noninterest-bearing liabilities include accrued interest payable and capital markets payables. The fair value is approximated by the book value.

***Preferred stock of subsidiary.*** The fair value is approximated by the current trade amount of similar instruments.

***Loan Commitments.*** Fair values are based on fees charged to enter into similar agreements taking into account the remaining terms of the agreements and the counterparties' credit standing.

***Other Commitments.*** Fair values are based on fees charged to enter into similar agreements.

## Note 24 ❑ Securitizations

During 2005 and 2004, FHN securitized $29.5 billion and $26.4 billion, respectively, of single-family residential loans in primarily proprietary and agency securitization transactions, and the resulting securities were sold as senior and subordinate certificates. In 2005 and 2004, FHN recognized net pre-tax gains of $321.9 million and $196.9 million, respectively, from the sale of securitized loans which includes gains recognized on the capitalization of MSR associated with these loans. In 2005 and 2004, FHN capitalized approximately $437.1 million and $319.2 million, respectively, in originated MSR. These MSR, as well as other MSR held by FHN, are discussed further in Note 6 – Mortgage Servicing Rights. In certain cases, FHN continues to service and receive servicing fees related to the securitized loans, and has also retained residual interest certificates or financial assets including excess interest (structured as interest-only strips), principal-only strips, interest-only strips, or subordinated bonds. FHN received annual servicing fees approximating .32 percent in 2005 and .31 percent in 2004 of the outstanding balance of underlying mortgage loans. FHN received annual servicing fees approximating .50 percent in 2005 and 2004 of the outstanding balance of underlying loans for HELOC securitizations. Additionally, FHN retained rights to future cash flows on the HELOC securitizations arising after investors in the securitization trust have received the return for which they contracted. The investors and the securitization trusts have no recourse to other assets of First Horizon Home Loans or FHN for failure of debtors to pay when due.

The sensitivity of the current fair value of all retained or purchased interests for MSR to immediate 10 percent and 20 percent adverse changes in assumptions on December 31, 2005, are as follows:

| *(Dollars in thousands* | MSR | MSR | MSR |
|---|---|---|---|
| *except for annual cost to service)* | 1st Liens | 2nd Liens | HELOC |
| **December 31, 2005** | | | |
| Fair value of retained interests | $1,314,597 | $5,470 | $14,384 |
| Weighted average life (in years) | 6.5 | 2.8 | 2.0 |
| Annual prepayment rate | 11.8% | 30.0% | 49.0% |
| Impact on fair value of 10% adverse change | $ (48,523) | $ (461) | $ (971) |
| Impact on fair value of 20% adverse change | (96,281) | (681) | (1,932) |
| Annual discount rate on residual cash flows | 10.1% | 14.0% | 18.0% |
| Impact on fair value of 10% adverse change | $ (49,192) | $ (238) | $ (310) |
| Impact on fair value of 20% adverse change | (97,395) | (371) | (604) |
| Annual cost to service (per loan) | $ 46 | $ 50 | $ 50 |
| Impact on fair value of 10% adverse change | (9,970) | (234) | (221) |
| Impact on fair value of 20% adverse change | (23,034) | (349) | (442) |
| Annual earnings on escrow | 4.1% | 2.9% | 4.4% |
| Impact on fair value of 10% adverse change | $ (24,615) | $ (211) | $ (561) |
| Impact on fair value of 20% adverse change | (52,324) | (303) | (1,121) |

## Note 24 ❑ Securitizations (continued)

The sensitivity of the current fair value of retained interests for other residuals to immediate 10 percent and 20 percent adverse changes in assumptions on December 31, 2005, are as follows:

| | | | | | Residual | Residual |
|---|---|---|---|---|---|---|
| | Excess | | | | Interest | Interest |
| *(Dollars in thousands* | Interest | Certificated | | Subordinated | Certificates | Certificates |
| *except for annual cost to service)* | IO | PO | IO | Bonds | 2nd Liens | HELOC |
| **December 31, 2005** | | | | | | |
| Fair value of retained interests | $230,683 | $ 9,386 | $ 634 | $4,684 | $9,316 | $47,638 |
| Weighted average life (in years) | 7.4 | 4.2 | 1.0 | 6.5 | 2.5 | 2.0 |
| Annual prepayment rate | 8.5% | 18.0% | 65.3% | 30.0% | 30.0% | 44.0% |
| Impact on fair value of 10% adverse change | $ (6,869) | $ (2,359) | $ 120 | $ (1) | $ (288) | $ (2,275) |
| Impact on fair value of 20% adverse change | (14,464) | (2,690) | 258 | (1) | (546) | (4,358) |
| Annual discount rate on residual cash flows | 11.5% | 10.8% | 13.0% | 22.1% | 20.0% | 18.0% |
| Impact on fair value of 10% adverse change | $ (8,587) | $ (2,358) | $ (10) | $ (157) | $ (408) | $ (1,459) |
| Impact on fair value of 20% adverse change | (17,617) | (2,633) | (11) | (305) | (786) | (2,825) |

These sensitivities are hypothetical and should not be considered to be predictive of future performance. As the figures indicate, changes in fair value based on a 10 percent variation in assumptions generally cannot necessarily be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated independently from any change in another assumption. In reality, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities. Furthermore, the estimated fair values as disclosed should not be considered indicative of future earnings on these assets.

FHN uses assumptions and estimates in determining the fair value allocated to retained interests at the time of initial securitization. The key economic assumptions used to measure the fair value of the MSR at the date of securitization were as follows:

| | MSR | MSR | MSR |
|---|---|---|---|
| | 1st Liens | 2nd Liens | HELOC |
| **2005** | | | |
| Weighted average life (in years) | 5.4-6.6 | N/A | N/A |
| Annual prepayment rate | 11.5%-15.2% | N/A | N/A |
| Annual discount rate | 10.06%-10.14% | N/A | N/A |
| Annual cost to service (per loan) | $45-$46 | N/A | N/A |
| Annual earnings on escrow | 3.21%-4.31% | N/A | N/A |
| 2004 | | | |
| Weighted average life (in years) | 5.0-6.5 | 2.9 | 1.7-2.0 |
| Annual prepayment rate | 11.3%-16.1% | 30.0% | 40%-45% |
| Annual discount rate | 10.1%-10.2% | 20.0% | 18%-20% |
| Annual cost to service (per loan) | $44-$45 | $50 | $50 |
| Annual earnings on escrow | 2.73%-3.76% | 2.0% | 2.0% |

N/A - not applicable

## Note 24 ❑ Securitizations (continued)

The key economic assumptions used to measure the fair value of other retained interests at the date of securitization were as follows:

| | Excess Interest IO | Certificated PO | IO | Subordinated Bond | Residual Interest Certificates 2nd Liens | Residual Interest Certificates HELOC |
|---|---|---|---|---|---|---|
| **2005** | | | | | | |
| Weighted average life (in years) | 5.8-7.2 | 3.0-5.7 | N/A | N/A | N/A | N/A |
| Annual prepayment rate | 8.3%-11.8% | 13.6%-23.3% | N/A | N/A | N/A | N/A |
| Annual discount rate | 11.5% | 5.6%-14.54% | N/A | N/A | N/A | N/A |
| 2004 | | | | | | |
| Weighted average life (in years) | 5.1-6.8 | 1.8-9.4 | 3.3-6.2 | 7.6 | 2.9 | 1.7-2.0 |
| Annual prepayment rate | 9.3%-14.4% | 7.6%-40.0% | 25.0% | 40.0% | 30.0% | 40%-45% |
| Annual discount rate | 11.5% | 5.11%-17.93% | 13.0% | 6.1%-8.8% | 20.0% | 18%-20% |

N/A – not applicable

FTN Financial Capital Assets Corporation (FTNFCAC), an indirect wholly-owned subsidiary of FHN, enters into transactions where mortgage loans are purchased, pooled, securitized and sold. During 2005 and 2004, $701.0 million and $154.6 million of mortgage loans were sold for pre-tax gains of $8.4 million and $3.3 million, respectively, that were recognized in capital markets noninterest income. FTNFCAC does not retain servicing rights or any other form of retained interest on these securitizations.

FHN has also securitized certain real estate loans through a real estate mortgage investment conduit (REMIC) in prior years and retained all of the securitized assets. Fair value for these securities was based upon cash flows discounted at a market yield. Market yields were computed by adding Treasury yields at year-end plus an appropriate spread estimated by observing quotes on similarly structured marketable securities and changes in swap spreads.

For the years ended December 31, 2005, 2004 and 2003, cash flows received and paid related to securitizations were as follows:

| *(Dollars in thousands)* | **2005** | 2004 | 2003 |
|---|---|---|---|
| Proceeds from initial securitizations | **$30,379,770** | $26,834,087 | $47,037,436 |
| Servicing fees retained** | **287,290** | 232,566 | 186,728 |
| Purchases of GNMA guaranteed mortgages | **212,145** | 315,646 | 554,483 |
| Purchases of delinquent or foreclosed assets | **9,260** | 13,213 | 33,581 |
| Other cash flows received on retained interests* | **76,425** | 57,637 | 181,512 |

* Other cash flows include all cash flows from other retained interests and REMIC securities.

** Includes servicing fees on originated, securitized and purchased MSR.

As of December 31, 2005, the principal amount of loans securitized and other loans managed with them, and the principal amount of delinquent loans, in addition to net credit losses during 2005 are as follows:

| *(Dollars in thousands)* | Total Principal Amount of Loans | Principal Amount of Delinquent Loans* | Net Credit Losses |
|---|---|---|---|
| | **On December 31, 2005** | | **For the Year Ended December 31, 2005** |
| Type of loan: | | | |
| Real estate residential | $79,776,689 | $487,503 | $21,868 |
| Total loans managed or securitized** | 79,776,689 | $487,503 | $21,868 |
| Loans securitized and sold | (67,504,477) | | |
| Loans held for sale or securitization | (3,915,069) | | |
| Loans held in portfolio | $ 8,357,143 | | |

* Loans 90 days or more past due include $173.4 million of GNMA guaranteed mortgages.

** Securitized loans are real estate residential loans in which FHN has a retained interest other than servicing rights.

## Note 25 ❑ Derivatives and Off-Balance Sheet Arrangements

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. ALCO, in conjunction with credit officers, also periodically reviews counterparty creditworthiness.

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 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. Changes in the instrument's fair value are recognized currently in earnings or other comprehensive income. If certain criteria are met and hedge accounting under SFAS No. 133 is achieved, changes in the fair value of the asset or liability being hedged are also recognized currently in earnings. Cash flows from derivative contracts are reported as operating activities on the Consolidated 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.

Mortgage Banking

Mortgage banking interest rate lock commitments are short-term commitments to fund mortgage loan applications in process (the pipeline) for a fixed term at a fixed price. During the term of an interest rate lock commitment, First Horizon Home Loans has the risk that interest rates will change from the rate quoted to the borrower. First Horizon Home Loans enters into forward sales contracts with respect to fixed rate loan commitments and futures contracts with respect to adjustable rate loan commitments as economic hedges designed to protect the value of the interest rate lock commitments from changes in value due to changes in interest rates. Under SFAS No. 133 interest rate lock commitments qualify as derivative financial instruments and as such do not qualify for hedge accounting treatment. As a result, the interest rate lock commitments are recorded at fair value with changes in fair value recorded in current earnings as gain or loss on the sale of loans in mortgage banking noninterest income. See Note 1–Summary of Significant Accounting Policies–for impact of SAB No. 105 on the valuation of interest rate lock commitments. Changes in the fair value of the derivatives that serve as economic hedges of interest rate lock commitments are also included in current earnings as a component of gain or loss on the sale of loans in mortgage banking noninterest income.

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

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

Warehouse loans qualifying for SFAS No. 133 hedge accounting treatment totaled $1.4 billion and $.6 billion on December 31, 2005 and 2004, respectively. The balance sheet impacts of the related derivatives were net liabilities of $.5 million and $2.3 million on December 31, 2005 and 2004, respectively.

First Horizon Home Loans also enters into interest rate contracts (including swaps, swaptions, and mortgage forward sales) to hedge against the effects of changes in fair value of its MSR due solely to changes in the benchmark rate (10-year LIBOR swap rate). All capitalized MSR are hedged for economic purposes with the vast majority of MSR routinely qualifying for hedge accounting. For purposes of measuring effectiveness of the hedge, time decay and recognized net interest income, including changes in value attributable to changes in spot and forward prices, if applicable, are excluded from the change in value of the related derivatives. Interest rate derivative contracts used to hedge against interest rate risk in the servicing portfolio are designated to specific risk tranches of servicing. First Horizon Home Loans enters into hedges of the MSR to minimize the effects of loss in value of MSR associated with increased prepayment activity that generally results from declining interest rates. In a rising interest rate environment, the value of the MSR generally will increase while the value of the hedge instruments will decline. Hedges are reset at least monthly and more frequently, as needed, to respond to changes in interest rates or hedge composition. Generally, a coverage ratio approximating 100 percent is maintained on hedged MSR. Prior to acquiring a new hedge instrument, First Horizon Home Loans performs a prospective evaluation of anticipated hedge effectiveness by reviewing the historical regression between the underlying index of the proposed hedge instrument and the mortgage rate. At the end of each hedge period, the change in the fair value of the hedged MSR asset due to the change in benchmark interest rate is calculated and becomes a historical data point. Retrospective hedge effectiveness is determined by performing a regression analysis of all collected data points over a rolling 12-month period. Effective hedging under SFAS No. 133 results in adjustments to the recorded value of the MSR. These basis adjustments, as well as the change in fair value of derivatives attributable to effective hedging, are included as a component of servicing income in mortgage banking noninterest income. MSR subject to SFAS No. 133 hedges totaled $1.3 billion and $1.0 billion on December 31, 2005 and 2004, respectively. The balance sheet impacts of the related derivatives were a net liability of $21.2 million on December 31, 2005, and a net asset of $79.0 million on December 31, 2004.

The following table summarizes certain information related to mortgage banking hedging activities for the years ended December 31:

| *(Dollars in thousands)* | **2005** | 2004 | 2003 |
|---|---|---|---|
| **Warehouse loans** | | | |
| Fair value hedge ineffectiveness net (losses)/gains | **$(1,168)** | $(16,571) | $29,909 |
| **Mortgage servicing rights** | | | |
| Fair value hedge ineffectiveness net (losses)/gains | **(1,891)** | 1,373 | 19,715 |
| Net gains excluded from assessment of effectiveness* | **13,884** | 46,546 | 95,420 |

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

First Horizon Home Loans uses different MSR stratification for purposes of determining hedge effectiveness pursuant to SFAS No. 133 and impairment testing pursuant to SFAS No. 140. The hedge results under SFAS No. 133 are allocated at a loan level and the loans are then aggregated into the SFAS No. 140 strata. This adjusted MSR basis is subsequently compared to the full fair value of the MSR to test for asset impairment. MSR basis is reduced to the extent that adjusted basis exceeds fair value. This reduction in basis as a result of impairment is a component of servicing income in mortgage banking noninterest income.

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

### Capital Markets

Capital Markets trades U.S. Treasury, U.S. Agency, mortgage-backed, corporate and municipal fixed income securities and other securities for distribution to customers. When these securities settle on a delayed basis, they are considered forward contracts. Capital Markets also enters into interest rate contracts, including options, caps, swaps, futures and floors for its customers. In addition, Capital Markets enters into futures contracts to economically hedge interest rate risk associated with its

## Note 25 ❑ Derivatives and Off-Balance Sheet Arrangements (continued)

securities inventory. These transactions are measured at fair value, with changes in fair value recognized currently in capital markets noninterest income. Related assets are recorded on the balance sheet as other assets and any liabilities are recognized as other liabilities. Credit risk related to these transactions is controlled through credit approvals, risk control limits and ongoing monitoring procedures through ALCO.

In fourth quarter 2005, Capital Markets utilized a forward contract as a cash flow hedge of the risk of change in the fair value of a forecasted sale of certain loans. It is expected that $77 thousand of net losses recorded in other comprehensive income on December 31, 2005, will be recognized in earnings in first quarter 2006. 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.

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 $61.2 million and $149.7 million on December 31, 2005 and 2004, respectively, and certain long-term debt obligations, totaling $1.2 billion on December 31, 2005 and 2004. These swaps have been accounted for as fair value hedges under the short cut method. The balance sheet impact of these swaps was $1.6 million in other assets and $28.3 million in other liabilities on December 31, 2005, and was $13.9 million in other assets and $11.2 million in other liabilities on December 31, 2004. Interest paid or received for these swaps is recognized as an adjustment of the interest expense of the liabilities whose risk is being managed. In addition, FHN has entered into certain interest rate swaps and caps as a part of our relationship with loan customers. These derivatives are not designated as hedging instruments and are entered into as part of a product offering to our 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.

### Off-Balance Sheet Arrangements

***Credit-Related Commitments.*** FHN enters into fixed and variable loan commitments with customers. When these commitments have contract rate adjustments that lag changes in market rates, the financial instruments have characteristics similar to option contracts. FHN follows the same credit policies and underwriting practices in making commitments as it does for on-balance sheet instruments. Each counterparty's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if any, is based on management's credit evaluation of the counterparty.

Commitments to extend credit are contractual obligations to lend to a customer as long as all established contractual conditions are met. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The majority of FHN's loan commitments has maturities less than one year and reflects the prevailing market rates at the time of the commitment. Since commitments may expire without being fully drawn upon, total contractual amounts do not necessarily represent future credit exposure or liquidity requirements.

Other commitments include standby and commercial letters of credit and other credit enhancements. Standby and commercial letters of credit and other credit enhancements are conditional commitments issued by FHN to guarantee the performance and/or payment of a customer to a third party in connection with specified transactions. The credit risk involved in issuing these commitments is essentially the same as that involved in extending loan facilities to customers, as performance under any of these facilities would result in a loan being funded to the customer.

FHN services loans for others, and, in some cases, provides guarantees or recourse on the serviced loans. See Note 18–Restrictions, Contingencies and Other Disclosures for additional information.

The following is a summary of each class of credit-related commitments outstanding on December 31:

| *(Dollars in millions)* | **2005** | 2004 |
|---|---|---|
| Commitments to extend credit: | | |
| Consumer credit card lines | **$ 2,432.5** | $ 2,002.3 |
| Consumer home equity | **6,991.3** | 5,868.7 |
| Commercial real estate and construction and land development | **3,686.0** | 2,489.0 |
| Commercial and other | **3,822.8** | 3,262.3 |
| Total loan commitments | **16,932.6** | 13,622.3 |
| Other commitments: | | |
| Standby letters of credit | **724.6** | 618.8 |
| Other | **47.0** | 84.4 |
| Total loan and other commitments | **$ 17,704.2** | $ 14,325.5 |

***Variable Interest Entities.*** On December 31, 2003, FHN adopted FIN 46 which addressed consolidation of VIE, and on March 31, 2004, adopted FIN 46-R which clarified certain of the provisions of FIN 46. A VIE exists when equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities by itself. Under the provisions of FIN 46, FHN is deemed to be the primary beneficiary and required to consolidate the VIE if it has a variable interest that will absorb the majority of the VIE's expected losses, receive the majority of expected residual returns, or both. A variable interest is a contractual, ownership or other interest that changes with changes in the fair value of the VIE's net assets. Expected losses and expected residual returns are measures of variability in the expected cash flow of a VIE.

Upon adoption of FIN 46, FHN deconsolidated its subsidiary, First Tennessee Capital I (Capital I), which has issued $100.0 million of capital securities that are fully and unconditionally guaranteed by FHN. As a result of this deconsolidation the capital securities are not included on FHN's Statement of Condition. However, $103.0 million of junior subordinated debentures issued by FHN to Capital I is included in term borrowings (See Note 11–Guaranteed Preferred Beneficial Interests in First Horizon's Junior Subordinated Debentures). FHN did not consolidate or deconsolidate any other significant VIE in connection with the adoption of FIN 46, and accordingly, it did not have a material impact on FHN's financial position or results of operations. Upon adoption of FIN 46-R, FHN reassessed certain of its nonconsolidated interests as VIE but did not meet the criteria of primary beneficiary and, therefore, did not consolidate or deconsolidate any other significant VIE, and accordingly, it did not have a material impact on FHN's financial position or results of operations.

Since 1997, First Tennessee Housing Corporation (FTHC), a wholly-owned subsidiary, makes equity investments as a limited partner, in various partnerships that sponsor affordable housing projects utilizing the Low Income Housing Tax Credit (LIHTC) pursuant to Section 42 of the Internal Revenue Code. The purpose of these investments is to achieve a satisfactory return on capital and to support FHN's community reinvestment initiatives. The activities of the limited partnerships include the identification, development, and operation of multi-family housing that is leased to qualifying residential tenants generally within FHN's primary geographic region. On December 31, 2005 and 2004, FTHC's maximum exposure to loss resulting from LIHTC investments was $106.7 million and $112.9 million, respectively. This represents the investment value of $102.6 million and $106.3 million included in "Other assets" on the Consolidated Statements of Condition and unfunded commitments of $4.1 million and $6.6 million on December 31, 2005 and 2004, respectively.

## Note 26 ❑ Parent Company Financial Information

Following are condensed statements of the parent company:

| **Statements of Condition** | December 31 | |
|---|---|---|
| *(Dollars in thousands)* | **2005** | 2004 |
| **Assets:** | | |
| Cash | **$ 305** | $ 46 |
| Securities purchased from subsidiary bank under agreements to resell | **143,183** | 148,393 |
| Total cash and cash equivalents | **143,488** | 148,439 |
| Investment in bank time deposits | **16,477** | 30,777 |
| Securities available for sale | **29,197** | 32,976 |
| Notes receivable | **3,700** | - |
| Investments in subsidiaries: | | |
| Bank | **2,558,271** | 2,306,458 |
| Non-bank | **34,131** | 34,239 |
| Other assets | **272,958** | 249,683 |
| **Total assets** | **$3,058,222** | $2,802,572 |
| **Liabilities and shareholders' equity:** | | |
| Commercial paper and other short-term borrowings | **$ 10,695** | $ 23,712 |
| Accrued employee benefits and other liabilities | **307,424** | 278,834 |
| Term borrowings | **427,792** | 459,043 |
| Total liabilities | **745,911** | 761,589 |
| Shareholders' equity | **2,312,311** | 2,040,983 |
| **Total liabilities and shareholders' equity** | **$3,058,222** | $2,802,572 |

| **Statements of Income** | Year Ended December 31 | | |
|---|---|---|---|
| *(Dollars in thousands)* | **2005** | 2004 | 2003 |
| Dividend income: | | | |
| Bank | **$220,065** | $110,109 | $272,987 |
| Non-bank | **5,484** | 9,059 | 8,545 |
| Total dividend income | **225,549** | 119,168 | 281,532 |
| Interest income | **4,096** | 3,816 | 3,848 |
| Other income | **164** | 4,801 | 686 |
| Total income | **229,809** | 127,785 | 286,066 |
| Interest expense: | | | |
| Short-term debt | **487** | 252 | 314 |
| Term borrowings | **21,243** | 13,581 | 15,352 |
| Total interest expense | **21,730** | 13,833 | 15,666 |
| Compensation, employee benefits and other expense | **40,642** | 28,944 | 59,863 |
| Total expense | **62,372** | 42,777 | 75,529 |
| Income before income taxes and equity in undistributed net income of subsidiaries | **167,437** | 85,008 | 210,537 |
| Income tax benefit | **(33,172)** | (20,899) | (34,125) |
| Income before equity in undistributed net income of subsidiaries | **200,609** | 105,907 | 244,662 |
| Equity in undistributed net income/(loss) of subsidiaries: | | | |
| Bank | **236,525** | 349,999 | 229,404 |
| Non-bank | **866** | (1,498) | (757) |
| **Net income** | **$438,000** | $454,408 | $473,309 |

## Note 26 ❑ Parent Company Financial Information (continued)

| **Statements of Cash Flows** | Year Ended December 31 | | |
|---|---|---|---|
| *(Dollars in thousands)* | **2005** | 2004 | 2003 |
| **Operating activities:** | | | |
| Net income | **$438,000** | $454,408 | $473,309 |
| Less undistributed net income of subsidiaries | **237,391** | 348,501 | 228,647 |
| Income before undistributed net income of subsidiaries | **200,609** | 105,907 | 244,662 |
| Adjustments to reconcile income to net cash provided by operating activities: | | | |
| Deferred income tax provision/(benefit) | **2,572** | (10,657) | (319) |
| Depreciation and amortization | **10,886** | 5,122 | 9,182 |
| Loss on debt purchase | **-** | - | 5,766 |
| Loss/(gain) on sale of securities | **641** | (2,408) | (284) |
| Net increase in interest receivable and other assets | **(28,890)** | (63,809) | (116,934) |
| Net increase in interest payable and other liabilities | **19,523** | 69,293 | 108,740 |
| Total adjustments | **4,732** | (2,459) | 6,151 |
| Net cash provided by operating activities | **205,341** | 103,448 | 250,813 |
| **Investing activities:** | | | |
| Securities: | | | |
| Sales and prepayments | **62** | 20,926 | 356 |
| Purchases | **(175)** | (190) | (362) |
| Decrease/(increase) in investment in bank time deposits | **14,300** | 123,190 | (56,000) |
| Proceeds from sale of a subsidiary | **-** | - | 49,833 |
| Return on investment in subsidiary | **1,290** | 5,005 | 1,614 |
| Cash investments in subsidiaries | **(16,632)** | (10,000) | (1,930) |
| Net cash (used)/provided by investing activities | **(1,155)** | 138,931 | (6,489) |
| **Financing activities:** | | | |
| Common stock: | | | |
| Exercise of stock options | **41,289** | 67,935 | 77,591 |
| Cash dividends | **(214,024)** | (198,495) | (150,863) |
| Repurchase of shares | **(488)** | (184,224) | (209,263) |
| Term borrowings: | | | |
| Payment | **(22,897)** | (9,500) | (57,739) |
| Issuance | **-** | 204,186 | 99,350 |
| (Decrease)/increase in short-term borrowings | **(13,017)** | (8,081) | 4,098 |
| Net cash used by financing activities | **(209,137)** | (128,179) | (236,826) |
| Net (decrease)/increase in cash and cash equivalents | **(4,951)** | 114,200 | 7,498 |
| Cash and cash equivalents at beginning of year | **148,439** | 34,239 | 26,741 |
| Cash and cash equivalents at end of year | **$143,488** | $148,439 | $ 34,239 |
| Total interest paid | **$ 20,977** | $ 11,132 | $ 15,326 |
| Total income taxes paid | **171,930** | 159,700 | 133,950 |

# CONSOLIDATED HISTORICAL STATEMENTS OF INCOME (Unaudited)

| | | | | | | | Growth Rates (%) | |
|---|---|---|---|---|---|---|---|---|
| *(Dollars in millions except per share data)* | **2005** | 2004 | 2003 | 2002 | 2001 | 2000 | 05/04 | 05/00* |
| **Interest income:** | | | | | | | | |
| Interest and fees on loans | **$1,133.5** | $ 774.7 | $ 657.6 | $ 666.0 | $ 811.7 | $ 915.0 | 46.3 + | 4.4 + |
| Investment securities | **124.5** | 104.2 | 111.2 | 143.0 | 168.2 | 198.8 | 19.5 + | 8.9 - |
| Loans held for sale | **377.9** | 226.8 | 229.1 | 184.0 | 165.9 | 197.3 | 66.6 + | 13.9 + |
| Trading securities inventory | **138.5** | 53.4 | 50.5 | 43.7 | 48.6 | 34.4 | 159.4 + | 32.1 + |
| Other earning assets | **65.8** | 7.7 | 5.0 | 5.5 | 7.1 | 20.1 | 754.5 + | 26.8 + |
| Total interest income | **1,840.2** | 1,166.8 | 1,053.4 | 1,042.2 | 1,201.5 | 1,365.6 | 57.7 + | 6.1 + |
| **Interest expense:** | | | | | | | | |
| Deposits: | | | | | | | | |
| Savings | **.4** | .4 | .8 | 2.2 | 3.8 | 5.5 | - | 40.8 - |
| Checking interest and money market | **59.5** | 24.0 | 22.8 | 37.1 | 84.9 | 110.8 | 147.9 + | 11.7 - |
| Certificates of deposit under $100,000 and other time | **79.0** | 60.1 | 57.1 | 71.2 | 111.1 | 129.2 | 31.4 + | 9.4 - |
| Certificates of deposit $100,000 and more | **364.0** | 108.0 | 69.4 | 79.8 | 137.1 | 254.9 | 237.0 + | 7.4 + |
| Trading liabilities | **80.2** | 20.0 | 22.1 | 16.0 | 10.1 | 11.8 | 301.0 + | 46.7 + |
| Short-term borrowings | **171.9** | 47.8 | 40.0 | 51.7 | 135.4 | 228.2 | 259.6 + | 5.5 - |
| Term borrowings | **101.1** | 50.2 | 35.4 | 28.6 | 30.2 | 24.3 | 101.4 + | 33.0 + |
| Total interest expense | **856.1** | 310.5 | 247.6 | 286.6 | 512.6 | 764.7 | 175.7 + | 2.3 + |
| **Net interest income** | **984.1** | 856.3 | 805.8 | 755.6 | 688.9 | 600.9 | 14.9 + | 10.4 + |
| Provision for loan losses | **67.7** | 48.3 | 86.7 | 92.2 | 93.2 | 67.5 | 40.2 + | .1 + |
| **Net interest income after provision** | **916.4** | 808.0 | 719.1 | 663.4 | 595.7 | 533.4 | 13.4 + | 11.4 + |
| **Noninterest income:** | | | | | | | | |
| Mortgage banking | **482.9** | 444.8 | 649.5 | 436.7 | 285.0 | 122.5 | 8.6 + | 31.6 + |
| Capital markets | **353.0** | 376.5 | 538.9 | 448.0 | 344.3 | 118.7 | 6.3 - | 24.4 + |
| Deposit transactions and cash management | **156.2** | 148.5 | 146.7 | 143.3 | 133.6 | 116.1 | 5.2 + | 6.1 + |
| Merchant processing | **88.6** | 75.1 | 57.6 | 48.4 | 45.4 | 48.2 | 18.0 + | 12.9 + |
| Insurance commissions | **54.1** | 56.1 | 57.8 | 50.4 | 16.8 | 12.2 | 3.6 - | 34.7 + |
| Revenue from loan sales and securitizations | **47.6** | 23.1 | - | - | - | - | 105.8 + | NM |
| Trust services and investment management | **44.6** | 47.3 | 45.9 | 48.4 | 56.7 | 65.8 | 5.6 - | 7.5 - |
| Gains on divestitures | **7.0** | 7.0 | 22.5 | 4.6 | 80.4 | 157.6 | NM | NM |
| Equity securities (losses)/gains, net | **(.6)** | 2.0 | 8.5 | (9.4) | (3.3) | .8 | NM | NM |
| Debt securities gains/(losses), net | **-** | 18.7 | (6.1) | .2 | (1.0) | (5.0) | NM | NM |
| All other income | **166.3** | 164.0 | 146.3 | 141.3 | 137.1 | 160.2 | 1.4 + | .8 + |
| Total noninterest income | **1,399.7** | 1,363.1 | 1,667.6 | 1,311.9 | 1,095.0 | 797.1 | 2.7 + | 11.9 + |
| **Adjusted gross income after provision** | **2,316.1** | 2,171.1 | 2,386.7 | 1,975.3 | 1,690.7 | 1,330.5 | 6.7 + | 11.7 + |
| **Noninterest expense:** | | | | | | | | |
| Employee compensation, incentives and benefits | **998.2** | 915.0 | 995.6 | 830.6 | 670.9 | 508.3 | 9.1 + | 14.4 + |
| Occupancy | **106.0** | 89.4 | 83.6 | 76.7 | 69.1 | 80.5 | 18.6 + | 5.7 + |
| Operations services | **79.6** | 67.5 | 67.9 | 60.2 | 59.6 | 70.9 | 17.8 + | 2.3 + |
| Equipment rentals, depreciation and maintenance | **77.1** | 72.7 | 69.0 | 68.7 | 74.1 | 68.2 | 6.1 + | 2.5 + |
| Communications and courier | **56.1** | 49.6 | 50.5 | 45.1 | 42.2 | 41.9 | 13.1 + | 6.0 + |
| Amortization of intangible assets | **13.7** | 9.5 | 8.0 | 6.2 | 10.8 | 11.7 | 43.9 + | 3.2 + |
| All other expense | **340.2** | 300.6 | 393.1 | 329.7 | 275.4 | 212.0 | 13.2 + | 9.9 + |
| Total noninterest expense | **1,670.9** | 1,504.3 | 1,667.7 | 1,417.2 | 1,202.1 | 993.5 | 11.1 + | 11.0 + |
| **Income before income taxes** | **645.2** | 666.8 | 719.0 | 558.1 | 488.6 | 337.0 | 3.2 - | 13.9 + |
| Provision for income taxes | **204.1** | 212.4 | 245.7 | 181.6 | 162.2 | 104.4 | 3.9 - | 14.3 + |
| **Income before cumulative effect of changes in accounting principle** | **441.1** | 454.4 | 473.3 | 376.5 | 326.4 | 232.6 | 2.9 - | 13.7 + |
| Cumulative effect of changes in accounting principle, net of tax | **(3.1)** | - | - | - | (8.2) | - | NM | NM |
| **Net income** | **$ 438.0** | $ 454.4 | $ 473.3 | $ 376.5 | $ 318.2 | $ 232.6 | 3.6 - | 13.5 + |
| **Fully taxable equivalent adjustment** | **$ 1.1** | $ 1.1 | $ 1.3 | $ 1.5 | $ 2.1 | $ 2.6 | - | 15.8 - |
| **Earnings per common share before cumulative effect of changes in accounting principle** | **$ 3.52** | $ 3.64 | $ 3.73 | $ 2.97 | $ 2.55 | $ 1.79 | 3.3 - | 14.5 + |
| **Earnings per common share** | **$ 3.49** | $ 3.64 | $ 3.73 | $ 2.97 | $ 2.49 | $ 1.79 | 4.1 - | 14.3 + |
| **Diluted earnings per common share before cumulative effect of changes in accounting principle** | **$ 3.42** | $ 3.54 | $ 3.62 | $ 2.89 | $ 2.48 | $ 1.77 | 3.4 - | 14.1 + |
| **Diluted earnings per common share** | **$ 3.40** | $ 3.54 | $ 3.62 | $ 2.89 | $ 2.42 | $ 1.77 | 4.0 - | 13.9 + |

* Compound annual growth rate.

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

NM - Due to the variable nature of these items the growth rate is considered to be not meaningful.

## CONSOLIDATED AVERAGE BALANCE SHEETS AND RELATED YIELDS AND RATES (Unaudited)

| | **2005** | | | 2004 | | | Average |
|---|---|---|---|---|---|---|---|
| | | Interest | Average | | Interest | Average | Balance |
| *(Fully taxable equivalent)* | Average | Income/ | Yields/ | Average | Income/ | Yields/ | Growth (%) |
| *(Dollars in millions)* | Balance | Expense | Rates | Balance | Expense | Rates | 05/04 |
| **Assets:** | | | | | | | |
| Earning assets: | | | | | | | |
| Loans, net of unearned income** | **$18,294.4** | **$1,133.9** | **6.20%** | $15,384.6 | $ 775.1 | 5.04% | 18.9 + |
| Loans held for sale | **6,020.4** | **377.9** | **6.28** | 4,179.4 | 226.8 | 5.43 | 44.0 + |
| Investment securities: | | | | | | | |
| U.S. Treasuries | **41.7** | **1.1** | **2.57** | 48.4 | .8 | 1.67 | 13.8 - |
| U.S. government agencies | **2,635.3** | **115.1** | **4.37** | 2,194.9 | 95.6 | 4.35 | 20.1 + |
| States and municipalities | **4.7** | **.2** | **5.01** | 10.8 | .7 | 6.52 | 56.5 - |
| Other | **198.3** | **8.7** | **4.39** | 195.0 | 7.7 | 3.96 | 1.7 + |
| Total investment securities | **2,880.0** | **125.1** | **4.34** | 2,449.1 | 104.8 | 4.28 | 17.6 + |
| Capital markets securities inventory | **2,155.6** | **101.4** | **4.70** | 753.1 | 26.8 | 3.56 | 186.2 + |
| Mortgage banking trading securities | **303.5** | **37.2** | **12.27** | 221.3 | 26.7 | 12.05 | 37.1 + |
| Other earning assets: | | | | | | | |
| Federal funds sold and securities purchased under agreements to resell | **2,288.0** | **65.5** | **2.86** | 722.2 | 7.6 | 1.06 | 216.8 + |
| Investment in bank time deposits | **8.1** | **.3** | **3.47** | 8.6 | .1 | 1.04 | 5.8 - |
| Total other earning assets | **2,296.1** | **65.8** | **2.87** | 730.8 | 7.7 | 1.06 | 214.2 + |
| Total earning assets | **31,950.0** | **1,841.3** | **5.76** | 23,718.3 | 1,167.9 | 4.92 | 34.7 + |
| Allowance for loan losses | **(175.3)** | | | (165.2) | | | 6.1 + |
| Cash and due from banks | **752.2** | | | 739.2 | | | 1.8 + |
| Capital markets receivables | **574.0** | | | 212.2 | | | 170.5 + |
| Premises and equipment, net | **394.2** | | | 364.4 | | | 8.2 + |
| Other assets | **3,065.3** | | | 2,436.9 | | | 25.8 + |
| Total assets/Interest income | **$36,560.4** | **$1,841.3** | | $27,305.8 | $1,167.9 | | 33.9 + |
| **Liabilities and shareholders' equity:** | | | | | | | |
| Interest-bearing liabilities: | | | | | | | |
| Interest-bearing deposits: | | | | | | | |
| Savings | **$ 290.8** | **$ .4** | **.14%** | $ 293.8 | $ .4 | .14% | 1.0 - |
| Checking interest and money market | **4,322.8** | **59.5** | **1.38** | 3,846.1 | 24.0 | .62 | 12.4 + |
| Certificates of deposit under $100,000 and other time | **2,242.8** | **79.0** | **3.52** | 1,947.0 | 60.1 | 3.08 | 15.2 + |
| Total interest-bearing core deposits | **6,856.4** | **138.9** | **2.03** | 6,086.9 | 84.5 | 1.39 | 12.6 + |
| Certificates of deposit $100,000 and more | **10,896.3** | **364.0** | **3.34** | 6,875.3 | 108.0 | 1.57 | 58.5 + |
| Federal funds purchased and securities sold under agreements to repurchase | **4,582.2** | **136.6** | **2.98** | 3,685.2 | 45.1 | 1.22 | 24.3 + |
| Capital markets trading liabilities | **1,519.3** | **80.2** | **5.28** | 527.0 | 20.0 | 3.80 | 188.3 + |
| Commercial paper and other short-term borrowings | **994.8** | **35.3** | **3.55** | 136.7 | 2.7 | 1.96 | 627.7 + |
| Term borrowings | **2,560.1** | **101.1** | **3.96** | 2,248.0 | 50.2 | 2.24 | 13.9 + |
| Total interest-bearing liabilities | **27,409.1** | **856.1** | **3.12** | 19,559.1 | 310.5 | 1.59 | 40.1 + |
| Demand deposits | **1,896.1** | | | 1,805.6 | | | 5.0 + |
| Other noninterest-bearing deposits | **3,367.0** | | | 2,867.7 | | | 17.4 + |
| Capital markets payables | **404.0** | | | 174.9 | | | 131.0 + |
| Other liabilities | **1,110.9** | | | 992.5 | | | 11.9 + |
| Guaranteed preferred beneficial interests in First Horizon's junior subordinated debentures (Note 11) | **-** | | | - | | | - |
| Preferred stock of subsidiary (Note 12) | **229.9** | | | .5 | | | NM |
| Shareholders' equity | **2,143.4** | | | 1,905.5 | | | 12.5 + |
| Total liabilities and shareholders' equity/Interest expense | **$36,560.4** | **$ 856.1** | | $27,305.8 | $ 310.5 | | 33.9 + |
| Net interest income-tax equivalent basis/Yield | | **$ 985.2** | **3.08%** | | $ 857.4 | 3.62% | |
| Fully taxable equivalent adjustment | | **(1.1)** | | | (1.1) | | |
| Net interest income | | **$ 984.1** | | | $ 856.3 | | |
| Net interest spread | | | **2.64%** | | | 3.33% | |
| Effect of interest-free sources used to fund earning assets | | | **.44** | | | .29 | |
| Net interest margin | | | **3.08%** | | | 3.62% | |

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

Yields and corresponding income amounts are adjusted to a fully taxable equivalent. Earning assets yields are expressed net of unearned income. Rates are expressed net of unamortized debenture cost for long-term debt. Net interest margin is computed using total net interest income.

| 2003 | | | 2002 | | | 2001 | | | 2000 | | | Average |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Interest | Average | | Interest | Average | | Interest | Average | | Interest | Average | Balance |
| Average | Income/ | Yields/ | Average | Income/ | Yields/ | Average | Income/ | Yields/ | Average | Income/ | Yields/ | Growth (%) |
| Balance | Expense | Rates | Balance | Expense | Rates | Balance | Expense | Rates | Balance | Expense | Rates | 05/00* |
| $12,656.3 | $ 658.1 | 5.20% | $10,634.5 | $ 666.6 | 6.27% | $10,104.3 | $ 812.5 | 8.04% | $ 9,932.0 | $ 915.9 | 9.22% | 13.0 + |
| 4,420.7 | 229.1 | 5.18 | 3,024.2 | 184.0 | 6.09 | 2,388.0 | 165.9 | 6.95 | 2,450.8 | 197.3 | 8.05 | 19.7 + |
| 45.3 | .7 | 1.62 | 55.5 | 1.7 | 3.04 | 31.5 | 1.6 | 4.98 | 33.0 | 2.1 | 6.41 | 4.8 + |
| 2,107.6 | 88.7 | 4.21 | 1,819.7 | 106.8 | 5.87 | 1,781.0 | 116.5 | 6.54 | 1,734.7 | 117.7 | 6.78 | 8.7 + |
| 22.1 | 1.5 | 6.80 | 34.9 | 2.5 | 7.30 | 50.8 | 3.8 | 7.53 | 48.7 | 3.6 | 7.49 | 37.4 - |
| 369.9 | 21.0 | 5.69 | 556.3 | 32.8 | 5.89 | 732.0 | 47.5 | 6.49 | 1,046.3 | 76.8 | 7.34 | 28.3 - |
| 2,544.9 | 111.9 | 4.40 | 2,466.4 | 143.8 | 5.83 | 2,595.3 | 169.4 | 6.53 | 2,862.7 | 200.2 | 6.99 | .1 + |
| 894.3 | 33.7 | 3.76 | 734.4 | 31.2 | 4.25 | 681.9 | 36.6 | 5.37 | 519.5 | 34.7 | 6.68 | 32.9 + |
| 154.7 | 16.9 | 10.94 | 131.3 | 12.6 | 9.55 | 127.5 | 12.1 | 9.48 | - | - | - | N/A |
| 656.3 | 4.9 | .75 | 404.8 | 5.4 | 1.35 | 226.5 | 7.0 | 3.07 | 328.4 | 20.0 | 6.10 | 47.4 + |
| 1.7 | .1 | .82 | 1.8 | .1 | 2.07 | 1.9 | .1 | 6.56 | 2.1 | .1 | 5.07 | 31.0 + |
| 658.0 | 5.0 | .75 | 406.6 | 5.5 | 1.35 | 228.4 | 7.1 | 3.10 | 330.5 | 20.1 | 6.09 | 47.4 + |
| 21,328.9 | 1,054.7 | 4.94 | 17,397.4 | 1,043.7 | 6.00 | 16,125.4 | 1,203.6 | 7.46 | 16,095.5 | 1,368.2 | 8.50 | 14.7 + |
| (160.3) | | | (151.2) | | | (145.2) | | | (140.0) | | | 4.6 + |
| 748.3 | | | 775.3 | | | 756.5 | | | 815.8 | | | 1.6 - |
| 460.1 | | | 256.2 | | | 208.2 | | | 56.6 | | | 58.9 + |
| 300.7 | | | 246.3 | | | 268.7 | | | 294.6 | | | 6.0 + |
| 2,455.9 | | | 2,180.0 | | | 2,013.6 | | | 2,202.8 | | | 6.8 + |
| $25,133.6 | $1,054.7 | | $20,704.0 | $1,043.7 | | $19,227.2 | $1,203.6 | | $19,325.3 | $1,368.2 | | 13.6 + |
| | | | | | | | | | | | | |
| $ 306.1 | $ .8 | .27% | $ 302.7 | $ 2.2 | .72% | $ 304.4 | $ 3.8 | 1.26% | $ 337.4 | $ 5.5 | 1.64% | 2.9 - |
| 3,659.7 | 22.8 | .62 | 3,557.5 | 37.1 | 1.04 | 3,548.2 | 84.9 | 2.39 | 3,371.5 | 110.8 | 3.29 | 5.1 + |
| 1,866.3 | 57.1 | 3.06 | 1,937.1 | 71.2 | 3.68 | 2,092.3 | 111.1 | 5.31 | 2,310.3 | 129.2 | 5.59 | .6 - |
| 5,832.1 | 80.7 | 1.38 | 5,797.3 | 110.5 | 1.91 | 5,944.9 | 199.8 | 3.36 | 6,019.2 | 245.5 | 4.08 | 2.6 + |
| 5,165.5 | 69.4 | 1.34 | 3,843.0 | 79.8 | 2.08 | 3,142.7 | 137.1 | 4.36 | 3,959.7 | 254.9 | 6.44 | 22.4 + |
| 3,712.7 | 36.9 | .99 | 3,134.3 | 45.5 | 1.45 | 3,162.7 | 115.6 | 3.66 | 2,899.4 | 169.4 | 5.84 | 9.6 + |
| 547.1 | 22.1 | 4.04 | 360.3 | 16.0 | 4.44 | 190.2 | 10.1 | 5.34 | 177.1 | 11.8 | 6.64 | 53.7 + |
| 151.1 | 3.1 | 2.06 | 177.1 | 6.2 | 3.50 | 375.1 | 19.8 | 5.27 | 873.3 | 58.8 | 6.74 | 2.6 + |
| 1,342.9 | 35.4 | 2.64 | 685.5 | 28.6 | 4.17 | 521.5 | 30.2 | 5.79 | 384.3 | 24.3 | 6.34 | 46.1 + |
| 16,751.4 | 247.6 | 1.48 | 13,997.5 | 286.6 | 2.05 | 13,337.1 | 512.6 | 3.84 | 14,313.0 | 764.7 | 5.34 | 13.9 + |
| 2,076.0 | | | 1,882.0 | | | 1,660.7 | | | 1,759.2 | | | 1.5 + |
| 3,038.0 | | | 2,152.5 | | | 1,792.3 | | | 1,193.9 | | | 23.0 + |
| 401.5 | | | 193.4 | | | 182.7 | | | 56.3 | | | 48.3 + |
| 944.1 | | | 766.0 | | | 709.1 | | | 618.8 | | | 12.4 + |
| 100.0 | | | 100.0 | | | 100.0 | | | 100.0 | | | 100.0 - |
| 22.2 | | | 44.3 | | | 44.0 | | | 7.5 | | | 98.3 + |
| 1,800.4 | | | 1,568.3 | | | 1,401.3 | | | 1,276.6 | | | 10.9 + |
| $25,133.6 | $ 247.6 | | $20,704.0 | $ 286.6 | | $19,227.2 | $ 512.6 | | $19,325.3 | $ 764.7 | | 13.6 + |
| | $ 807.1 | 3.78% | | $ 757.1 | 4.35% | | $ 691.0 | 4.29% | | $ 603.5 | 3.75% | |
| | (1.3) | | | (1.5) | | | (2.1) | | | (2.6) | | |
| | $ 805.8 | | | $ 755.6 | | | $ 688.9 | | | $ 600.9 | | |
| | | 3.46% | | | 3.95% | | | 3.62% | | | 3.16% | |
| | | .32 | | | .40 | | | .67 | | | .59 | |
| | | 3.78% | | | 4.35% | | | 4.29% | | | 3.75% | |

* Compound annual growth rate

** Includes loans on nonaccrual status.

NM – The growth rate is considered to be not meaningful.

*Notwithstanding anything to the contrary set forth in any of our filings with the Securities and Exchange Commission under the securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, that might incorporate future filings by reference, including the annual report on Form 10-K or the proxy statement, in whole or in part, the following "Information Concerning Certain Officer Certifications" is not a component of any such filings and shall not be incorporated by reference into any such filings. It is disclosed in our annual report to shareholders and accompanies our proxy statement in accordance with applicable rules of the New York Stock Exchange.*

### Information Concerning Certain Officer Certifications

Our chief executive officer and our chief financial officer each year make certain certifications that are included as Exhibits 31(a) and 31(b) to our annual report on Form 10-K which is filed with the Securities and Exchange Commission.

A copy of our most recent annual report on Form 10-K, including the financial statements and schedules thereto, is available free of charge to each shareholder of record upon written request to the treasurer, First Horizon National Corporation, P.O. Box 84, Memphis, Tennessee 38101. Each such written request must set forth a good faith representation that as of the record date specified in the notice of our 2006 annual shareholders meeting the person making the request was a beneficial owner of a security entitled to vote at the annual meeting of shareholders. The exhibits to the annual report on Form 10-K also will be supplied upon written request to the treasurer and payment to us of the cost of furnishing the requested exhibit or exhibits. That report (including Exhibits 31(a) and 31(b)) also is available to the public without charge through the U.S. Securities and Exchange Commission's website at www.sec.gov.

In addition, shortly after our 2005 shareholders meeting, our chief executive officer submitted a certification to the New York Stock Exchange concerning our compliance with certain listing requirements related to corporate governance. That certification contained no qualifications.

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# Shareholder Information

**Corporate Headquarters**
165 Madison Avenue
Memphis, TN 38103
(800) 489-4040
www.fhnc.com

**Common Stock**

Our common stock is listed on the New York Stock Exchange and traded under the symbol FHN. At December 31, 2005, there were 8,209 shareholders of record of our common stock.

**Stock Transfer Agent**
Wells Fargo Shareowner Services
(877) 536-3558

- For answers to questions about stock transfers, changes of address, dividend payments or lost certificates
- To receive general information or an enrollment card for direct deposit of dividend checks
- To eliminate duplicate mailings of financial information
- To receive information about our dividend reinvestment and stock purchase plan

**Investor Relations**
(800) 410-4577
InvestorRelations@FirstHorizon.com

**Media Relations**
(800) 355-0340
MediaRelations@FirstHorizon.com

**Principal Corporate Subsidiaries**
Federal Flood Certification Corp.
First Express Remittance Processing Inc.
FHEL Inc.
FHRF Inc.
FHRIII LLC
FHRIV LLC
FHTRS Inc.
First Horizon Asset Securities Inc.
First Horizon Home Loan Corp.
First Horizon Insurance Services Inc.
First Horizon Mint Distribution Inc.
First Horizon Mortgage Loan Corp.
First Horizon Msaver Inc.
First Tennessee Bank National Association
First Tennessee Brokerage Inc.
First Tennessee Housing Corp.
First Tennessee Insurance Services Inc.
First Tennessee Mortgage Services Inc.
FTN Financial Capital Assets Corp.
FTN Financial Securities Corp.
FTN Midwest Securities Corp.
FT Building LLC
FT Insurance Corp.
FTN Premium Services Inc.
FT Real Estate Securities Company Inc.
FT Reinsurance Company
Hickory Capital Corp.
Hickory Venture Capital Corp.
Highland Capital Management Corp.
Martin & Company Inc.
Norlen Life Insurance Company
Synaxis Group Inc.

FIRST HORIZON
NATIONAL CORPORATION