CNA SURETY CORP
Form 10-Q
October 29, 2010

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2010

OR

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

For the transition period from __________ to __________

Commission file number: 1-13277
CNA SURETY CORPORATION
(Exact name of Registrant as specified in its Charter)

DELAWARE	**36-4144905**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
333 S. WABASH AVE., CHICAGO, ILLINOIS	**60604**
(Address of principal executive offices)	**(Zip Code)**

(312) 822-5000
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller Reporting Company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). o Yes þ No

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY
PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. o Yes o No

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

44,366,975 shares of Common Stock, $.01 par value as of October 21, 2010.

CNA SURETY CORPORATION AND SUBSIDIARIES
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CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	September 30, 2010	December 31, 2009
	(Amounts in thousands, except per share data)	
Assets		
Invested assets:		
Fixed income securities, at fair value (amortized cost: $1,327,229 and $1,219,270)	$ 1,428,878	$ 1,266,223
Equity securities, at fair value (cost: $1,736 and $1,429)	1,947	1,610
Short-term investments, at amortized cost (approximates fair value)	39,514	48,999
Total invested assets	1,470,339	1,316,832
Cash	7,600	5,822
Deferred policy acquisition costs	102,698	99,836
Insurance receivables:		
Premiums, including $10,640 and $9,753 from affiliates, (net of allowance for doubtful accounts: $1,315 and $1,110)	44,664	33,392
Reinsurance	49,486	48,645
Deposit with affiliated ceding company	23,425	26,878
Goodwill and other intangible assets (net of accumulated amortization: $25,523 and $25,523)	138,785	138,785
Property and equipment, at cost (less accumulated depreciation and amortization: $40,046 and $37,514)	16,803	19,681
Prepaid reinsurance premiums	180	210
Accrued investment income	15,915	15,832
Other assets, including $359 and $0 receivables from affiliates	2,458	3,122
Total assets	$ 1,872,353	$ 1,709,035
Liabilities		
Reserves:		
Unpaid losses and loss adjustment expenses	$ 439,943	$ 406,123
Unearned premiums	257,114	247,776
Total reserves	697,057	653,899
Long-term debt	30,930	30,930
Deferred income taxes, net	46,751	28,065
Reinsurance and other payables to affiliates		548
Accrued expenses	17,023	18,586
Liability for postretirement benefits	11,007	10,718
Payable for securities purchased		1,356
Income tax payable	3,816	13,389

Other liabilities	24,917	28,460
Total liabilities	831,501	785,951
Commitments and contingencies (See Notes 3, 5, & 8)		
Stockholders Equity		
Common stock, par value $.01 per share, 100,000 shares authorized; 45,693 shares issued and 44,337 shares outstanding at September 30, 2010 and 45,635 shares issued and 44,268 shares outstanding at December 31, 2009	457	456
Additional paid-in capital	281,448	279,388
Retained earnings	707,422	627,505
Accumulated other comprehensive income	66,085	30,406
Treasury stock, 1,356 and 1,367 shares, at cost	(14,560)	(14,671)
Total stockholders equity	1,040,852	923,084
Total liabilities and stockholders equity	$ 1,872,353	$ 1,709,035

The accompanying notes are an integral part of these condensed consolidated financial statements.

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CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
	(Amount in thousands, except per share data)			
Revenues:				
Net earned premium	$ 110,275	$ 109,703	$ 313,741	$ 316,549
Net investment income	13,465	12,536	39,629	37,359
Net realized investment gains (losses):				
Other-than-temporary impairment losses				(1,870)
Portion of other-than-temporary impairment losses recognized in other comprehensive income (before taxes)			(122)	1,708
Net impairment losses recognized in earnings			(122)	(162)
Net realized investment gains, excluding impairment losses	8	1,056	1,191	1,105
Total net realized investment gains	8	1,056	1,069	943
Total revenues	123,748	123,295	354,439	354,851
Expenses:				
Net losses and loss adjustment expenses	19,095	24,429	69,272	84,992
Net commissions, brokerage and other underwriting expenses	59,609	62,169	168,202	172,364
Interest expense	299	319	871	1,096
Total expenses	79,003	86,917	238,345	258,452
Income before income taxes	44,745	36,378	116,094	96,399
Income tax expense	14,258	10,854	36,177	27,844
Net income	$ 30,487	$ 25,524	$ 79,917	$ 68,555
Earnings per common share	$ 0.69	$ 0.58	$ 1.80	$ 1.55
Earnings per common share, assuming dilution	$ 0.69	$ 0.57	$ 1.80	$ 1.54
Weighted average shares outstanding	44,327	44,263	44,305	44,240
Weighted average shares outstanding, assuming dilution	44,487	44,411	44,458	44,397

The accompanying notes are an integral part of these condensed consolidated financial statements.

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CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
(UNAUDITED)

	Common Stock Shares Outstanding	Common Stock	Additional Paid-in Capital	Comprehensive Income	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock At Cost	Total Stockholders' Equity
				(Amounts in thousands)				
Balance, January 1, 2009	44,168	$ 455	$ 276,255		$ 509,644	$ (4,286)	$ (14,773)	$ 767,295
Comprehensive income:								
Net income		$	$	$ 68,555	$ 68,555	$	$	$ 68,555
Other comprehensive income:								
Change in unrealized gains (losses) on securities, after income tax expense of $25,317 (net of reclassification adjustment of ($2,550), after income tax benefit of $1,373)				47,016		47,016		47,016
Other-than-temporary impairment losses not recognized in the Condensed Consolidated Statements of Income, after income tax benefit of $146				(270)		(270)		(270)
Net change related to postretirement benefits, after income tax benefit of $178				(531)		(531)		(531)
Total comprehensive income				$ 114,770				
Stock-based compensation			1,453					1,453
Stock options exercised and other	99	1	1,141				102	1,244

Balance, September 30, 2009	44,267	$ 456	$ 278,849		$ 578,199	$ 41,929	$ (14,671)	$ 884,762
Balance, January 1, 2010	44,268	$ 456	$ 279,388		$ 627,505	$ 30,406	$ (14,671)	$ 923,084
Comprehensive income:								
Net income		$	$	$ 79,917	$ 79,917	$	$	$ 79,917
Other comprehensive income:								
Change in unrealized gains on securities, after income tax expense of $19,049 (net of reclassification adjustment of $828, after income tax expense of $445)				35,376		35,376		35,376
Other-than-temporary impairment losses not recognized in the Condensed Consolidated Statements of Income, after income tax expense of $105 (net of reclassification adjustment of ($79), after income tax benefit of $43)				196		196		196
Net change related to postretirement benefits, after income tax expense of $57				107		107		107
Total comprehensive income				$ 115,596				
Stock-based compensation			1,322					1,322
Stock options exercised and other	69	1	738				111	850
Balance, September 30, 2010	44,337	$ 457	$ 281,448		$ 707,422	$ 66,085	$ (14,560)	$ 1,040,852

The accompanying notes are an integral part of these condensed consolidated financial statements.

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CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Nine Months Ended September 30,	
	2010	2009
	(Amounts in thousands)	
Cash Flows from Operating Activities:		
Net income	$ 79,917	$ 68,555
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for doubtful accounts	422	543
Depreciation and amortization	4,622	4,516
Amortization of bond premium, net	5,443	3,534
(Gain) loss on disposal or impairment of property and equipment	(77)	4,921
Net realized investment gains	(1,069)	(943)
Deferred income taxes, net	(622)	(449)
Stock-based compensation	1,322	1,453
Changes in:		
Insurance receivables	(12,535)	35,771
Reserve for unearned premiums	9,338	3,792
Reserve for unpaid losses and loss adjustment expenses	33,820	(438)
Deposit with affiliated ceding company	3,453	2,325
Deferred policy acquisition costs	(2,862)	(2,989)
Reinsurance and other payables to/receivables from affiliates	(907)	(1,590)
Prepaid reinsurance premiums	30	154
Accrued expenses	(1,563)	(5,751)
Other assets and liabilities	(11,627)	(3,702)
Net cash provided by operating activities	107,105	109,702
Cash Flows from Investing Activities:		
Fixed income securities:		
Purchases	(182,941)	(260,383)
Maturities	45,251	84,747
Sales	25,295	50,115
Purchases of equity securities	(373)	(715)
Proceeds from the sale of equity securities	86	528
Changes in short-term investments	9,529	10,209
Purchases of property and equipment, net	(1,667)	(3,612)
Changes in receivables/payables for securities sold/purchased	(1,357)	(8,398)
Net cash (used in) investing activities	(106,177)	(127,509)
Cash Flows from Financing Activities:		
Employee stock option exercises and other	850	1,244
Investment custody account bank overdraft		14,857

Net cash provided by financing activities	850	16,101
Increase (decrease) in cash	1,778	(1,706)
Cash at beginning of period	5,822	9,596
Cash at end of period	$ 7,600	$ 7,890

Supplemental Disclosure of Cash Flow Information:

Cash paid during the period for:		
Interest	$ 867	$ 1,126
Income taxes	$ 46,279	$ 28,059

The accompanying notes are an integral part of these condensed consolidated financial statements.

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CNA SURETY CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2010
(UNAUDITED)

1. Significant Accounting Policies

Formation of CNA Surety Corporation and Merger

In December 1996, CNA Financial Corporation (CNAF) and Capsure Holdings Corp. (Capsure) agreed to merge (the Merger) the surety business of CNAF with Capsure s insurance subsidiaries, Western Surety Company (Western Surety), Surety Bonding Company of America (Surety Bonding) and Universal Surety of America (Universal Surety), into CNA Surety Corporation (CNA Surety or the Company). CNAF, through its operating subsidiaries, writes multiple lines of property and casualty insurance, including surety business that is reinsured by Western Surety. The principal operating subsidiaries of CNAF that wrote the surety line of business for their own account prior to the Merger were Continental Casualty Company and its property and casualty affiliates (collectively, CCC) and The Continental Insurance Company and its property and casualty affiliates (collectively, CIC). Through its insurance subsidiaries, CNAF owns approximately 62% of the outstanding common stock of CNA Surety. Loews Corporation owns approximately 90% of the outstanding common stock of CNAF.

Principles of Consolidation

The Condensed Consolidated Financial Statements include the accounts of CNA Surety and all majority-owned subsidiaries.

Estimates

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

Basis of Presentation

These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Company s 2009 Form 10-K. Certain financial information that is included in annual financial statements prepared in accordance with GAAP is not required for interim reporting and has been condensed or omitted. The accompanying unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all adjustments necessary for a fair presentation of the interim financial statements. All such adjustments are of a normal and recurring nature. The financial results for interim periods may not be indicative of financial results for a full year.

Earnings Per Share

Basic earnings per common share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per common share is computed based on the weighted average number of shares outstanding plus the dilutive effect of common stock equivalents which is computed using the treasury stock method.

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The computation of earnings per common share is as follows (amounts in thousands, except for per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Net income	$ 30,487	$ 25,524	$ 79,917	$ 68,555
Shares:				
Weighted average shares outstanding	44,313	44,254	44,268	44,168
Weighted average shares of options exercised and additional stock issuance	14	9	37	72
Total weighted average shares outstanding	44,327	44,263	44,305	44,240
Effect of dilutive options	160	148	153	157
Total weighted average shares outstanding, assuming dilution	44,487	44,411	44,458	44,397
Earnings per share	$ 0.69	$ 0.58	$ 1.80	$ 1.55
Earnings per share, assuming dilution	$ 0.69	$ 0.57	$ 1.80	$ 1.54

No adjustments were made to reported net income in the computation of earnings per share. Options to purchase shares of common stock of 0.5 million and 0.8 million were excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2010 and September 30, 2009, respectively, because the exercise price of these options was greater than the average market price of CNA Surety s common stock.

Adopted Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2009-16, Transfers and Servicing (Topic 860) Accounting for Transfers of Financial Assets. This guidance removed the concept of a qualifying special-purpose entity and eliminated it from exceptions under the guidance for consolidation of variable interest entities. It also modified the de-recognition conditions related to legal isolation and effective control and added additional disclosure requirements for transfers of financial assets. This guidance was effective for annual reporting periods beginning after November 15, 2009. The adoption of this guidance did not have an impact on the Company s financial condition or results of operations.

In June 2009, the FASB issued ASU No. 2009-17, Consolidations (Topic 810) Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities. This guidance amended existing consolidation guidance applicable for variable interest entities as well as requirements for determination of the primary beneficiary of a variable interest entity, required an ongoing assessment of whether an entity is the primary beneficiary and required enhanced disclosures that will provide users of financial statements information regarding an enterprise s involvement in a variable interest entity. This guidance was effective for annual reporting periods beginning after November 15, 2009. The Company evaluated its trust preferred security arrangement discussed further in Note 6., Debt, to these Condensed Consolidated Financial Statements and determined the issuer trust should remain unconsolidated under this guidance. As such, the adoption of this guidance did not have an impact on the Company s financial condition or results of operations.

In April 2009, the FASB issued updated accounting guidance, which amended the other-than-temporary impairment (OTTI) loss model for fixed income securities. A fixed income security is impaired if the fair value of the security is less than its amortized cost basis, which is its cost adjusted for accretion, amortization and previously recorded OTTI losses. The updated accounting guidance requires an OTTI loss equal to the difference between fair value and amortized cost to be recognized in earnings if the Company intends to sell the fixed income security or if it is more likely than not the Company will be required to sell the fixed income security before recovery of its amortized cost basis.

The remaining fixed income securities in an unrealized loss position are evaluated to determine if a credit loss exists. If the Company does not expect to recover the entire amortized cost basis of a fixed income security, the security is deemed to be other-than-temporarily impaired for credit reasons. For these securities, the bifurcation of OTTI losses into a credit component and a non-credit component is required by the updated accounting guidance. The credit component is recognized in earnings and represents the difference between the present value of the future cash flows that the Company expects to collect and a fixed income security s amortized cost basis. The non-credit component is recognized in other comprehensive income and represents the difference between fair value and the present value of the future cash flows that the Company expects to collect.

Prior to the adoption of the updated accounting guidance, OTTI losses were not bifurcated between credit and non-credit components. The difference between fair value and amortized cost was recognized in earnings for all securities for which the

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Company did not expect to recover the amortized cost basis, or for which the Company did not have the ability and intent to hold until recovery of fair value to amortized cost.

Pending Accounting Pronouncements

In October 2010, the FASB issued ASU No. 2010-26, Financial Services Insurance (Topic 944) Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts. This updated accounting guidance modifies the definition of the types of costs incurred to acquire or renew insurance contracts that may be capitalized. Under the new guidance, these costs include those costs that are incremental direct costs and certain costs that are directly related to successful contract acquisitions. This accounting guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011 with prospective or retrospective application allowed. The Company is currently assessing the available application methods as well as the impact this accounting guidance will have on its financial condition and results of operations.

2. Investments

Major categories of net investment income were as follows (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	**2009**	**2010**	**2009**
Investment income:				
Fixed income securities	$ 13,766	$ 12,763	$ 40,499	$ 37,790
Equity securities	10	8	28	27
Short-term investments	27	26	63	110
Other	11	14	35	48
Total investment income on available-for-sale securities	13,814	12,811	40,625	37,975
Investment income on deposit with affiliated ceding company	21	35	72	307
Investment expenses	(370)	(310)	(1,068)	(923)
Net investment income	$ 13,465	$ 12,536	$ 39,629	$ 37,359

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Net realized investment gains and losses and the net change in unrealized gains and losses of available-for-sale securities were as follows (dollars in thousands):

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Net realized investment gains (losses):				
Fixed income securities:				
Gross realized investment gains	$ 4	$ 1,448	$ 1,197	$ 1,491
Gross realized investment losses:				
Other-than-temporary impairment losses			(122)	(116)
Realized losses from sales	(5)	(392)	(26)	(392)
Total gross realized investment losses	(5)	(392)	(148)	(508)
Net realized investment (losses) gains on fixed income securities	(1)	1,056	1,049	983
Equity securities:				
Gross realized investment gains	8		20	27
Gross realized investment losses:				
Other-than-temporary impairment losses				(46)
Realized losses from sales				(20)
Total gross realized investment losses				(66)
Net realized investment gains (losses) on equity securities	8		20	(39)
Other	1			(1)
Net realized investment gains	$ 8	$ 1,056	$ 1,069	$ 943
Net change in unrealized gains:				
Fixed income securities	$ 29,656	$ 46,768	$ 54,696	$ 71,743
Equity securities	68	93	30	174
Total net change in unrealized gains	$ 29,724	$ 46,861	$ 54,726	$ 71,917
Net realized gains and change in unrealized gains	$ 29,732	$ 47,917	$ 55,795	$ 72,860

Management believes the Company has the ability to hold all fixed income securities to maturity. However, the Company may dispose of securities prior to their scheduled maturity due to changes in interest rates, prepayments, tax and credit considerations, liquidity or regulatory capital requirements, or other similar factors. As a result, the Company considers all of its fixed income securities (bonds) and equity securities as available-for-sale, and as such, they are carried at fair value.

The amortized cost, gross unrealized gains, gross unrealized losses, estimated fair value and unrealized OTTI losses of fixed income securities and the cost, gross unrealized gains, gross unrealized losses and estimated fair value of equity securities held by CNA Surety at September 30, 2010, by investment category, were as follows (dollars in thousands):

September 30, 2010	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses Less Than 12 Months	Gross Unrealized Losses More Than 12 Months	Estimated Fair Value	Unrealized OTTI Losses
Fixed income securities:						
U.S. Treasury securities and obligations of U.S. Government and agencies:						
U.S. Treasury	$ 17,287	$ 1,080	$	$	$ 18,367	$
U.S. Agencies	6,521	309			6,830	
Collateralized mortgage obligations residential	24,268	1,814			26,082	
Mortgage pass-through securities residential	75,569	3,426			78,995	
Obligations of states and political subdivisions	711,165	60,100		(786)	770,479	
Corporate bonds	458,489	34,253	(25)	(74)	492,643	
Collateralized mortgage obligations commercial	10,019	770			10,789	
Other asset-backed securities:						
Second mortgages/home equity loans residential	4,228			(242)	3,986	(1,021) [(a)]
Consumer credit receivables	9,997	282			10,279	
Other	9,686	742			10,428	
Total fixed income securities	1,327,229	102,776	(25)	(1,102)	1,428,878	$ (1,021)
Equity securities	1,736	211			1,947	
Total	$ 1,328,965	$ 102,987	$ (25)	$ (1,102)	$ 1,430,825	

(a) The unrealized loss position of this security was $0.2 million at September 30, 2010.

The amortized cost, gross unrealized gains, gross unrealized losses, estimated fair value and unrealized OTTI losses of fixed income securities and the cost, gross unrealized gains, gross unrealized losses and estimated fair value of equity securities held by CNA Surety at December 31, 2009, by investment category, were as follows (dollars in thousands):

December 31, 2009	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses Less Than 12 Months	Gross Unrealized Losses More Than 12 Months	Estimated Fair Value	Unrealized OTTI Losses
Fixed income securities:						
U.S. Treasury securities and obligations of U.S. Government and agencies:						
U.S. Treasury	$ 17,378	$ 970	$	$	$ 18,348	$
U.S. Agencies	9,794	337			10,131	
Collateralized mortgage obligations residential	30,709	1,383			32,092	
Mortgage pass-through securities residential	94,453	2,336	(232)		96,557	
Obligations of states and political subdivisions	696,505	35,847	(882)	(2,902)	728,568	
Corporate bonds	334,136	11,478	(1,248)	(257)	344,109	
Collateralized mortgage obligations commercial	10,024			(351)	9,673	
Other asset-backed securities:						
Second mortgages/home equity loans residential	5,501			(740)	4,761	(1,399) [(a)]
Consumer credit receivables	11,055	528			11,583	
Other	9,715	686			10,401	
Total fixed income securities	1,219,270	53,565	(2,362)	(4,250)	1,266,223	$ (1,399)
Equity securities	1,429	181			1,610	
Total	$ 1,220,699	$ 53,746	$ (2,362)	$ (4,250)	$ 1,267,833	

(a) The unrealized loss position of this security was $0.5 million at December 31, 2009.

A security is in an unrealized loss position, or impaired, if the fair value of the security is less than its amortized cost or cost, which includes adjustments for accretion, amortization and previously recorded other-than-temporary impairment losses. When a security is impaired, the impairment is evaluated to determine whether it is temporary or other-than-temporary.

A significant judgment in the valuation of investments is the determination of when an other-than-temporary decline in value has occurred. The Company follows a consistent and systematic process for identifying securities that sustain other-than-temporary declines in value. The Company has established a watch list that is reviewed by the Chief Financial Officer and one other executive officer on at least a quarterly basis. The watch list includes individual securities that fall below certain thresholds or that exhibit evidence of impairment indicators including, but not limited to, a significant adverse change in the financial condition and near-term prospects of the investment or a significant adverse change in legal factors, the business climate or credit ratings.

When a security is placed on the watch list, it is monitored for further market value changes and additional news related to the issuer s financial condition. The focus is on objective evidence that may influence the evaluation of impairment factors. The decision to record an other-than-temporary impairment loss incorporates both quantitative criteria and qualitative information.

In determining whether an equity security is other-than-temporarily impaired, the Company considers a number of factors including, but not limited to: (a) the length of time and the extent to which the market value has been less than book value, (b) the financial condition and near-term prospects of the issuer, (c) the intent and ability of the Company to retain its investment for a period of time sufficient to allow for any anticipated recovery in value and (d) general market conditions and industry or sector specific factors. Currently, the Company s equity portfolio is comprised solely of mutual funds related to the Company s deferred compensation plan, which is an unfunded, nonqualified deferred compensation plan for a select group of management or highly compensated employees. Due to the nature of the plan, the Company does not assert the ability to hold these securities until an anticipated recovery in value. As such, if any of these securities are in an unrealized loss position, they are considered to be other-than-temporarily impaired.

For equity securities for which an other-than-temporary impairment loss has been identified, the security is written down to fair value and the resulting losses are recognized in realized gains/losses in the Condensed Consolidated Statements of Income.

Fixed income securities in an unrealized loss position that the Company intends to sell, or it more likely than not will be required to sell before any anticipated recovery of amortized cost, are considered to be other-than-temporarily impaired. These securities are written down to fair value and the resulting losses are recognized in realized gains/losses in the Condensed Consolidated Statements of Income.

The remaining fixed income securities in an unrealized loss position are evaluated to determine if a credit loss exists. To determine if a credit loss exists, the Company considers a number of factors including, but not limited to: (a) the financial condition and near-term prospects of the issuer, (b) credit ratings of the securities, (c) whether the debtor is current on interest and principal payments, (d) the length of time and the extent to which the market value has been less than book value and (e) general market conditions and industry or sector specific factors.

In addition to these factors, the Company considers the results of discounted cash flow modeling using assumptions representative of current market conditions as well as those specific to the Company s particular security holdings. For asset-backed and mortgage-backed securities, the focus of this analysis is on assessing the sufficiency and quality of underlying collateral and timing of cash flows. Significant assumptions considered by the Company in its cash flow projections include delinquency rates, probable risk of default, over collateralization and credit support from lower level tranches. If the discounted expected cash flows for a security equal or exceed the amortized cost of that security, no credit loss exists and the security is deemed to be temporarily impaired.

Fixed income securities in an unrealized loss position for which management believes a credit loss exists are considered to be other-than-temporarily impaired. For these fixed income securities, the Company bifurcates OTTI losses into a credit component and a non-credit component. The credit component, which represents the difference between the discounted expected cash flows and the fixed income security s amortized cost, is recognized in earnings. The non-credit component is recognized in other comprehensive income and represents the difference between fair value and the discounted cash flows that the Company expects to collect.

Based on the Company s evaluation of this quantitative criteria and qualitative information, the Company did not record any credit-related OTTI losses during the three-month periods ended September 30, 2010 or 2009. The Company recorded credit-related OTTI losses of $0.1 million and $0.2 million during the nine months ended September 30, 2010 and 2009, respectively. These credit-related OTTI losses were recorded on a security collateralized by sub-prime home loans that is rated below investment grade by Standard & Poor s (S&P).

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The following table presents a roll-forward of the Company s cumulative credit losses recognized in net realized gains (losses) on the Condensed Consolidated Statements of Income on fixed income securities held as of September 30, 2010 (in thousands of dollars):

	Three Months Ended September 30		Nine Months Ended September 30	
Beginning balance	$	238	$	116
Credit losses for which an OTTI loss was not previously recognized				
Credit losses for which an OTTI loss was previously recognized				122
Ending balance	$	238	$	238

The following table presents a roll-forward of the Company s cumulative credit losses recognized in net realized gains (losses) on the Condensed Consolidated Statements of Income on fixed income securities held as of September 30, 2009 (in thousands of dollars):

	Three Months Ended September 30		Six Months Ended September 30	
Beginning balance	$	116	$	
Credit losses for which an OTTI loss was not previously recognized				116
Credit losses for which an OTTI loss was previously recognized				
Ending balance	$	116	$	116

For the three and nine months ended September 30, 2010, the Company has recorded no OTTI losses on equity securities. For the three months ended September 30, 2009, the Company did not record OTTI losses on equity securities; however, the Company recorded OTTI losses of less than $0.1 million on equity securities for the nine months ended September 30, 2009.

The amortized cost and estimated fair value of fixed income securities, by contractual maturity, at September 30, 2010 and December 31, 2009 are shown below. Actual maturities may differ from contractual maturities as borrowers may have the right to call or prepay obligations with or without call or prepayment penalties (dollars in thousands):

	September 30, 2010				December 31, 2009			
	Amortized Cost		Estimated Fair Value		Amortized Cost		Estimated Fair Value	
Fixed income securities:								
Due within one year	$	31,719	$	32,419	$	13,006	$	13,224
Due after one year but within five years		410,562		436,300		304,654		321,144
Due after five years but within ten years		464,094		514,311		447,485		468,254
Due after ten years		287,087		305,289		292,668		298,534
		1,193,462		1,288,319		1,057,813		1,101,156
Mortgage pass-through securities, collateralized mortgage obligations and		133,767		140,559		161,457		165,067

asset-backed securities

	$ 1,327,229	$ 1,428,878	$ 1,219,270	$ 1,266,223

The following table provides the composition of fixed income securities with an unrealized loss at September 30, 2010 in relation to the total of all fixed income securities in an unrealized loss position by contractual maturities:

Contractual Maturity	**% of Estimated Fair Value**	**% of Unrealized Loss**
Due after one year through five years	29%	9%
Due after five years through ten years	49	65
Due after ten years	16	5
Asset-backed securities	6	21
Total	100%	100%

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The following table summarizes for fixed income securities in an unrealized loss position at September 30, 2010 and December 31, 2009, the aggregate fair value and gross unrealized loss by length of time those securities have been continuously in an unrealized loss position (dollars in thousands):

	September 30, 2010		December 31, 2009	
Unrealized Loss Aging	**Estimated Fair Value**	**Gross Unrealized Loss**	**Estimated Fair Value**	**Gross Unrealized Loss**
Fixed income securities:				
Investment grade[a]:				
0-6 months	$	$	$ 162,087	$ 2,362
13-24 months			11,176	469
Greater than 24 months	8,155	422	32,932	2,065
Total investment grade	8,155	422	206,195	4,896
Non-investment grade:				
0-6 months	6,235	25		
Greater than 24 months	17,700	680	17,346	1,716
Total non-investment grade	23,935	705	17,346	1,716
Total	$ 32,090	$ 1,127	$ 223,541	$ 6,612

(a) Investment grade is determined by using the S&P rating. If a security is not rated by S&P, the Moody s Investor Services (Moody s) rating is used. As of September 30, 2010 and December 31, 2009, all of the Company s fixed income securities were rated by S&P or Moody s.

At September 30, 2010, the Company holds 320 fixed income securities in an unrealized gain position with a total estimated fair value of $1,396.8 million and an aggregate gross unrealized gain of $102.8 million.

The following table summarizes securities in a gross unrealized loss position by investment category and by credit rating. The table also discloses the corresponding count of securities in an unrealized loss position and estimated fair value by category (in thousands of dollars):

	Gross Unrealized Losses				Estimated
September 30, 2010	**A**	**BBB**	**Total**	**Count**	**Fair Value**
Fixed income securities:					
Investment grade[(a)]:					
Obligations of states and political subdivisions	$ 348	$	$ 348	1	$ 5,215
Corporate bonds		74	74	1	2,940
Total investment grade	348	74	422	2	8,155
Non-investment grade:					
Obligations of states and political subdivisions			438	2	15,716
Corporate bonds			25	4	6,235
Other asset-backed securities:					
Second mortgages/home equity loans residential			242	1	1,984
Total non-investment grade			705	7	23,935
Total	$ 348	$ 74	$ 1,127	9	$ 32,090

(a) Securities are categorized using the S&P rating. If a security is not rated by S&P, the Moody s rating is used. At September 30, 2010, all of the Company s fixed income securities were rated by S&P or Moody s.

As a result of improving market conditions, only two of the Company s investment grade fixed income securities were in an unrealized loss position at September 30, 2010. One security, issued by a governmental utility authority, had an unrealized loss of $0.3 million, or 6.3% of the security s amortized cost. The other security, issued by a large student loan provider, had an unrealized loss of $0.1 million, or 2.5% of the security s amortized cost. The unrealized loss on each of these securities has improved compared to December 31, 2009 when the unrealized losses were $0.6 million, or 11.3% of amortized cost, and $0.3 million, or 8.5% of amortized cost, respectively. The Company has no current intent to sell these securities, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost. The Company does not believe the unrealized losses on these securities are indicative of credit losses and, as such, has not recorded an OTTI loss on these securities at September 30, 2010.

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Seven of the Company s non-investment grade fixed income securities were in an unrealized loss position at September 30, 2010. Two of these securities in an unrealized loss position are obligations of states and political subdivisions. Both of these securities were issued by governmental utility authorities. At September 30, 2010, one of these securities had an unrealized loss of $0.1 million, or 1.0% of its amortized cost, and the other had an unrealized loss of $0.4 million, or 3.5% of its amortized cost. The unrealized loss position of these securities was $1.2 million in total at December 31, 2009. Based on the underlying fundamentals of these securities, the Company continues to believe that all interest and principal will be paid according to their contractual terms. The Company has no current intent to sell these securities, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost. As such, the Company has not recorded an OTTI loss on these securities at September 30, 2010.

During the third quarter of 2010, the Company purchased thirteen non-investment grade corporate bonds with an estimated fair value of $20.5 million at September 30, 2010. Four of these securities were in an unrealized loss position at September 30, 2010. In the aggregate, these four securities had an unrealized loss of less than $0.1 million as of September 30, 2010. Each of the individual securities was in an unrealized loss position representing less than 1.0% of that security s amortized cost. The Company has no current intent to sell these securities, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost. The Company does not believe the unrealized losses on these securities are indicative of credit losses and, as such, has not recorded an OTTI loss on these securities at September 30, 2010.

At September 30, 2010 the Company s exposure to sub-prime home loans was limited to two asset-backed securities collateralized by sub-prime home loans which originated prior to 2005. The estimated fair value of these securities was $4.0 million at September 30, 2010. One of these securities is in an unrealized loss position and rated below investment grade at September 30, 2010. During the nine months ended September 30, 2010, the Company received repayments on this security of $0.5 million, or approximately 18% of the par value outstanding at December 31, 2009. As discussed previously, this security was determined to have credit losses totaling $0.1 million during the nine months ended September 30, 2010. The non-credit component of this security s OTTI recognized in accumulated other comprehensive income at September 30, 2010 was $0.2 million. The Company believes the non-credit component of the unrealized loss on this security is primarily attributable to this asset class being out of favor with investors and is not indicative of the quality of the underlying collateral. The Company has no current intent to sell this security, nor is it more likely than not that it will be required to sell prior to recovery of the adjusted amortized cost.

Based on the current facts and circumstances discussed above for the Company s securities in an unrealized loss position, the Company has determined that no additional OTTI losses related to the securities in an unrealized loss position are required to be recorded at September 30, 2010.

Invested assets are exposed to various risks, such as interest rate, market and credit risks. Due to the level of risk associated with certain of these invested assets and the level of uncertainty related to changes in the value of these assets, it is possible that changes in risks in the near term may significantly affect the amounts reported in the Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Income.

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3. Reinsurance

The effect of reinsurance on the Company s written and earned premium was as follows (dollars in thousands):

	Three Months Ended September 30,			
	2010		2009	
	Written	Earned	Written	Earned
Direct	$ 91,299	$ 93,107	$ 90,472	$ 91,994
Assumed	22,485	23,269	22,930	24,813
Ceded	(6,079)	(6,101)	(7,041)	(7,104)
	$ 107,705	$ 110,275	$ 106,361	$ 109,703

	Nine Months Ended September 30,			
	2010		2009	
	Written	Earned	Written	Earned
Direct	$ 274,578	$ 262,968	$ 271,619	$ 262,628
Assumed	66,680	68,952	69,742	74,941
Ceded	(18,149)	(18,179)	(20,866)	(21,020)
	$ 323,109	$ 313,741	$ 320,495	$ 316,549

Assumed premiums primarily include surety business written or renewed, net of reinsurance, by CCC and CIC after September 30, 1997 that is reinsured by Western Surety pursuant to reinsurance and related agreements discussed below. Because of certain regulatory restrictions that limit Western Surety s ability to write certain business on a direct basis, the Company utilizes the underwriting capacity available through these agreements while retaining control of the underwriting and claim management of this assumed business.

Assumed premium also includes surety business written by another affiliate, First Insurance Company of Hawaii, Ltd. and its subsidiaries First Indemnity Insurance of Hawaii, Inc., First Fire and Casualty Insurance of Hawaii, Inc. and First Security Insurance of Hawaii, Inc. (collectively, FICOH). Through its insurance subsidiaries, CNAF owns approximately 50% of the outstanding common stock of First Insurance Company of Hawaii, Ltd. Under the terms of this excess of loss agreement that covers certain contract surety business, FICOH retains losses of $2 million per principal and Western Surety assumes 80% of $5 million per principal in excess of $2 million subject to an aggregate annual limit of $8 million. Premiums assumed by Western Surety under this agreement were less than $0.1 million for both the three months ended September 30, 2010 and 2009, respectively, and $0.1 million for both the nine months ended September 30, 2010 and 2009, respectively.

CNA Surety also assumes premium on contract and commercial surety bonds for international risks. Such premiums are assumed pursuant to the terms of reinsurance treaties or as a result of specific international bond requirements of domestic customers. For the three month periods ended September 30, 2010 and 2009, assumed premiums written under such arrangements were $0.7 million and $0.9 million, respectively. For the nine month periods ended September 30, 2010 and 2009, assumed premiums written under such arrangements were $3.3 million and $1.8 million, respectively.

The effect of reinsurance on the Company s provision for loss and loss adjustment expenses and the corresponding ratio to earned premium was as follows (dollars in thousands):

	Three Months Ended September 30,			
	2010		2009	
	$	Ratio	$	Ratio
Gross losses and loss adjustment expenses	$ 16,959	14.6%	$ 28,062	24.0%

Ceded amounts	2,136	(35.0)%	(3,633)	51.6%
Net losses and loss adjustment expenses	$ 19,095	17.3%	$ 24,429	22.3%

	Nine Months Ended September 30,			
	2010		**2009**	
	$	**Ratio**	**$**	**Ratio**
Gross losses and loss adjustment expenses	$ 68,081	20.5%	$ 92,115	27.3%
Ceded amounts	1,191	(6.6)%	(7,123)	33.9%
Net losses and loss adjustment expenses	$ 69,272	22.1%	$ 84,992	26.8%

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The unusual relationship in the gross and ceded amounts shown above for the three and nine months ended September 30, 2010 resulted from adjustments to the estimated loss and loss adjustment expense reserves during the three months ended September 30, 2010. The Company reduced gross reserves related to prior accident years by approximately $16.8 million reflecting changes in estimates of incurred-but-not-reported reserves. The corresponding change in ceded reserves was such that net reserves related to prior accident years were reduced by $13.0 million for the three months ended September 30, 2010.

Excess of Loss Reinsurance

The Company s ceded reinsurance program is predominantly comprised of excess of loss reinsurance contracts that limit the Company s retention on a per principal basis. The Company s reinsurance coverage is provided by third party reinsurers and related parties. Due to the terms of these excess of loss treaties, reinsurers may cover some principals in one year but then exclude these same principals in subsequent years. As a result, the Company may have exposures to these principals that have limited or no reinsurance coverage. Only the large national contractor discussed below was excluded from the third party reinsurance agreements effective for the treaty periods discussed; however, as discussed below, the Company has no further exposure to this principal.

2009 Third Party Reinsurance

Effective January 1, 2009, CNA Surety entered into an excess of loss treaty (2009 Excess of Loss Treaty) with a group of third party reinsurers on terms similar to the excess of loss treaty effective in 2008. Under the 2009 Excess of Loss Treaty, the Company s net retention per principal was $15 million with a 5% co-participation in the $90 million layer of third party reinsurance coverage above the Company s retention. The contract provided aggregate coverage of $185 million and included an optional extended discovery period, which was not exercised. The contract also included a provision for additional premiums of up to $13.8 million based on losses ceded under the contract. The actual ceded premiums for the 2009 Excess of Loss Treaty were $26.6 million.

2010 Third Party Reinsurance

Effective January 1, 2010, CNA Surety entered into an excess of loss treaty (2010 Excess of Loss Treaty) with a group of third party reinsurers on terms similar to the 2009 Excess of Loss Treaty. Under the 2010 Excess of Loss Treaty, the Company s net retention per principal remains at $15 million with a 5% co-participation in the $90 million layer of third party reinsurance coverage above the Company s retention. The contract provides aggregate coverage of $185 million and includes an optional extended discovery period, for an additional premium (a percentage of the original premium based on any unexhausted aggregate limit by layer), which will provide coverage for losses discovered beyond 2010 on bonds that were in force during 2010. The contract also includes a provision for additional premiums of up to $12.3 million based on losses ceded under the contract. The base annual premium for the 2010 Excess of Loss Treaty is $24.6 million.

Related Party Reinsurance

Reinsurance agreements together with the Services and Indemnity Agreement described below provide for the transfer of the surety business written by CCC and CIC to Western Surety. Many of these agreements originally were entered into on September 30, 1997 (the Merger Date) and include: (i) the Surety Quota Share Treaty (the Quota Share Treaty); (ii) the Aggregate Stop Loss Reinsurance Contract (the Stop Loss Contract) and (iii) the Surety Excess of Loss Reinsurance Contract. Although the contracts entered on the Merger Date have expired, some have been renewed on different terms as described below.

Through the Quota Share Treaty, CCC and CIC transfer to Western Surety surety business written or renewed by CCC and CIC after the Merger Date. The Quota Share Treaty was renewed on January 1, 2010 and expires on December 31, 2010 and is annually renewable thereafter. CCC and CIC transfer the related liabilities of such business and pay to Western Surety an amount in cash equal to CCC s and CIC s net written premiums written on all such business, minus a quarterly ceding commission to be retained by CCC and CIC equal to $50,000 plus 25% of net written premiums written on all such business. For 2009 this resulted in an override commission on their actual direct acquisition costs of 4.8% to CCC and CIC.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of the Merger Date by agreeing to pay Western Surety, within 30 days following the end of each calendar quarter, the amount of any adverse development on such reserves, as re-estimated as of the end of such calendar quarter. There was no adverse reserve development for the period from the Merger Date through September 30, 2010.

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Through the Stop Loss Contract, the Company s insurance subsidiaries were protected from adverse loss development on certain business underwritten after the Merger Date. The Stop Loss Contract between the Company s insurance subsidiaries and CCC limited the insurance subsidiaries prospective net loss ratios with respect to certain accounts and lines of insured business for three full accident years following the Merger Date. In the event the insurance subsidiaries accident year net loss ratio exceeds 24% in any of the accident years 1997 through 2000 on certain insured accounts (the Loss Ratio Cap), the Stop Loss Contract requires CCC at the end of each calendar quarter following the Merger Date, to pay to the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which the Company s actual accident year net loss ratio exceeds the applicable Loss Ratio Cap, multiplied by (ii) the applicable net earned premiums. In consideration for the coverage provided by the Stop Loss Contract, the Company s insurance subsidiaries paid CCC an annual premium of $20,000. The CNA Surety insurance subsidiaries have paid CCC all required annual premiums. Through September 30, 2010 and December 31, 2009, losses incurred under the Stop Loss Contract were $47.2 million and $49.1 million, respectively. The decrease is due to favorable development on claims subject to the Stop Loss Contract during the three months ended March 31, 2010. At September 30, 2010, the amount received under the Stop Loss Contract included $2.7 million held by the Company for losses covered under this contract that were incurred but not paid.

The Services and Indemnity Agreement provides the Company s insurance subsidiaries with the authority to perform various administrative, management, underwriting and claim functions in order to conduct the surety business of CCC and CIC and to be reimbursed by CCC for services rendered. In consideration for providing the foregoing services, CCC has agreed to pay Western Surety a quarterly fee of $50,000. In 2009, this agreement was amended so that the Company s authority to conduct administrative, management, underwriting and claim functions for bonds written for the large national contractor discussed below shall continue until CCC s bonds for such contractor have expired and claims have been settled or closed. This agreement was renewed on January 1, 2010 and expires on December 31, 2010 and is annually renewable thereafter. As of September 30, 2010 there were no amounts due to the CNA Surety insurance subsidiaries under this agreement.

From January 1, 2005 to June 30, 2009, the Company and CCC were parties to an excess of loss contract, and extensions to that contract, that provided unlimited reinsurance coverage in excess of $60 million retention for the life of bonds either in force or written during the contract periods exclusively for the one large national contractor excluded from the Company s third party reinsurance. Premiums for these contracts totaled $8.6 million and included an initial premium of $7.0 million and premiums of $1.6 million based on the level of premiums written on bonds for the large national contractor.

In 2009, the Company and CCC terminated the excess of loss contract discussed in the preceding paragraph. Related to the termination of this contract, the Company and CCC also commuted the Quota Share Treaty as regards the premium and losses for the large national contractor. The impact of this commutation was a decrease of gross loss reserves of $51.8 million. Under the terms of the agreements effecting this commutation, the Company paid CCC $1.8 million. This settlement reflected the difference between the Company s $60.0 million retention under the excess of loss contract and the $58.2 million paid by the Company for losses of the large national contractor through 2009.

On January 1, 2010, the Company and CCC entered into separate agreements that provide for the transfer of the Canadian surety business of CCC to Western Surety. These agreements, which include a quota share treaty (the Canadian Quota Share Treaty) and a services and indemnity agreement (the Canadian Services and Indemnity Agreement), are substantially similar to the Quota Share Treaty and the Services and Indemnity Agreement discussed above. The Canadian Services and Indemnity Agreement provides Western Surety with the authority to supervise various administrative, underwriting and claim functions associated with the surety business written by CCC, through its Canadian branch, on behalf of the Company. Through the Canadian Quota Share Treaty, this Canadian surety business is transferred to Western Surety. Pursuant to these agreements, CCC will transfer the subject premium and related liabilities of such business and pay to Western Surety an amount equal to CCC s net written premiums on all such business, minus a ceding commission of 33.5% of net written premiums. Further, Western Surety will pay an additional ceding commission to CCC in the amount of actual direct expense in producing such premium. These agreements expire on December 31, 2010 and are annually renewable thereafter.

As of September 30, 2010 and December 31, 2009, CNA Surety had an insurance receivable balance from CCC and CIC of $10.6 million and $9.8 million, respectively, comprised of premiums receivable. Also, at September 30, 2010, CNA Surety had a receivable of $0.4 million carried in Other assets in the Company s Condensed Consolidated Balance Sheets primarily related to the Administrative Services Agreement with CCC.

The Company s Condensed Consolidated Balance Sheets also include a Deposit with affiliated ceding company of $23.4 million and $26.9 million at September 30, 2010 and December 31, 2009, respectively. In 2005, pursuant to an agreement with the claimant on a bond regarding certain aspects of the claim resolution, the Company deposited $32.7 million with an affiliate to enable the affiliate to establish a trust to fund future payments under the bond. The bond was written by the affiliate and assumed by one of the Company s insurance subsidiaries pursuant to the Quota Share Treaty. The Company is entitled to the interest income earned by the trust. Prior to the establishment of the trust, the Company had fully reserved its obligation under the bond and the claim remains fully reserved.

4. Fair Value of Financial Instruments

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company uses the following fair value hierarchy in selecting inputs, with the highest priority given to Level 1, as these are the most transparent or reliable:

Level 1 Quoted prices for identical instruments in active markets.

Level 2 Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs are observable in active markets.

Level 3 Valuations derived from valuation techniques in which one or more significant inputs are unobservable.

The Company utilizes a pricing service for the valuation of the majority of securities held. This pricing service is an independent, third party vendor recognized to be an industry leader with access to market information who obtains or computes fair market values from quoted market prices, pricing for similar securities, recently executed transactions, cash flow models with yield curves and other pricing models. For valuations obtained from the pricing service, the Company performs due diligence to understand how the valuation was calculated or derived, focusing on the valuation technique used and the nature of the inputs.

The following section describes the valuation methodologies used to measure different financial instruments at fair value, including an indication of the level in the fair value hierarchy in which the instrument is generally classified.

Fixed Income Securities

Securities valued using Level 1 inputs include highly liquid government bonds for which quoted market prices are available. Securities using Level 2 inputs are valued using pricing for similar securities, recently executed transactions, cash flow models with yield curves and other pricing models utilizing observable inputs. Most fixed income securities are valued using Level 2 inputs. Level 2 includes corporate bonds, municipal bonds, asset-backed securities and mortgage pass-through securities.

Equity Securities

Level 1 includes publicly traded securities valued using quoted market prices.

Short-Term Investments

The valuation of securities that are actively traded or have quoted prices are classified as Level 1. These securities include money market funds and U.S. Treasury bills. Level 2 includes commercial paper, for which all significant inputs are observable.

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Assets measured at fair value on a recurring basis as of September 30, 2010 and December 31, 2009 are summarized below (amounts in thousands):

	September 30, 2010			
	Fair Value Measurement Using			Assets at Fair
	Level 1	Level 2	Level 3	Value
Assets:				
Fixed income securities:				
U.S. Treasury securities and obligations of U.S. Government and agencies:				
U.S. Treasury	$ 18,367	$	$	$ 18,367
U.S. Agencies		6,830		6,830
Collateralized mortgage obligations residential		26,082		26,082
Mortgage pass-through securities residential		78,995		78,995
Obligations of states and political subdivisions		770,479		770,479
Corporate bonds		492,643		492,643
Collateralized mortgage obligations commercial		10,789		10,789
Other asset-backed securities:				
Second mortgages/home equity loans residential		3,986		3,986
Consumer credit receivables		10,279		10,279
Other		10,428		10,428
Total fixed income securities	18,367	1,410,511		1,428,878
Equity securities at fair value	1,947			1,947
Short-term investments at fair value [(a)]	16,042	23,472		39,514
Total assets	$ 36,356	$ 1,433,983	$	$ 1,470,339

(a) Includes commercial paper, U.S. Government agency discount notes and money market funds.

	December 31, 2009			
	Fair Value Measurement Using			Assets at Fair
	Level 1	Level 2	Level 3	Value
Assets:				
Fixed income securities:				
U.S. Treasury securities and obligations of U.S. Government and agencies:				

U.S. Treasury	$ 18,348	$	$	$ 18,348
U.S. Agencies		10,131		10,131
Collateralized mortgage obligations residential		32,092		32,092
Mortgage pass-through securities residential		96,557		96,557
Obligations of states and political subdivisions		728,568		728,568
Corporate bonds		344,109		344,109
Collateralized mortgage obligations commercial		9,673		9,673
Other asset-backed securities:				
Second mortgages/home equity loans residential		4,761		4,761
Consumer credit receivables		11,583		11,583
Other		10,401		10,401
Total fixed income securities	18,348	1,247,875		1,266,223
Equity securities at fair value	1,610			1,610
Short-term investments at fair value [(a)]	15,412	33,587		48,999
Total assets	$ 35,370	$ 1,281,462	$	$ 1,316,832

(a) Includes commercial paper, U.S. Government agency discount notes and money market funds.

The Company had no transfers between levels in the fair value hierarchy requiring additional disclosure.

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5. Reserves for Losses and Loss Adjustment Expenses

Activity in the reserves for unpaid losses and loss adjustment expenses was as follows (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Reserves at beginning of period:				
Gross	$ 439,344	$ 419,812	$ 406,123	$ 428,724
Ceded reinsurance	53,040	40,796	50,968	83,691
Net reserves at beginning of period	386,304	379,016	355,155	345,033
Net incurred loss and loss adjustment expenses:				
Provision for insured events of current year	32,088	32,291	91,265	92,907
(Decrease) in provision for insured events of prior years	(12,993)	(7,862)	(21,993)	(7,915)
Total net incurred	19,095	24,429	69,272	84,992
Net payments attributable to:				
Current year events	5,643	6,717	9,736	10,323
Prior year events	11,568	11,843	26,483	34,817
Total net payments	17,211	18,560	36,219	45,140
Foreign currency transaction adjustments	67		47	
Net reserves at end of period	388,255	384,885	388,255	384,885
Ceded reinsurance at end of period	51,688	43,401	51,688	43,401
Gross reserves at end of period	$ 439,943	$ 428,286	$ 439,943	$ 428,286

The Company recorded net loss reserve development for prior accident years which resulted in a decrease of the estimated liability of $13.0 million and $22.0 million for the three and nine-month periods ended September 30, 2010 compared to $7.9 million for both the three and nine-month periods ended September 30, 2009.

The favorable development for the nine months ended September 30, 2010 resulted primarily from a level of loss activity that continues to be substantially below expectations for accident years 2006 and 2007. Favorable levels of loss activity for accident year 2006 were reflected in the favorable development for the six months ended June 30, 2010. This favorable claim activity for 2006 continued through the three months ended September 30, 2010. Management believes that experience for the 2007 accident year is sufficiently credible to indicate that adjustments to reserves for the 2007 accident year are appropriate at September 30, 2010. The level of loss activity continues to be particularly influenced by lower than expected emergence of large claims. The Company s initial estimates of losses for accident year 2010 and the estimates for accident years 2008 and 2009 continue to reflect the impact of less favorable economic conditions.

The favorable development for the three and nine months ended September 30, 2009 reflected adjustments of the reserves for accident years 2004 and prior as a result of specific indemnity recoveries and reductions in case reserves and for accident year 2006 as a result of claim activity substantially below expectations.

6. Debt

In May 2004, the Company, through a wholly-owned trust, privately issued $30.0 million of preferred securities through two pooled transactions. These securities, issued by CNA Surety Capital Trust I (the Issuer Trust), bear interest at the London Interbank Offered Rate (LIBOR) plus 337.5 basis points with a 30-year term. Beginning in May 2009, these securities may be redeemed, in whole or in part, at par value at any scheduled quarterly interest payment date. As of September 30, 2010, none of these preferred securities have been redeemed.

The Company s investment of $0.9 million in the Issuer Trust is carried at cost in Other assets in the Company s Condensed Consolidated Balance Sheets. The sole asset of the Issuer Trust consists of a $30.9 million junior subordinated debenture issued by the Company to the Issuer Trust. Due to the underlying characteristics of this debt, the carrying value of the debenture approximates its estimated fair value.

The Company has also guaranteed the dividend payments and redemption of the preferred securities issued by the Issuer Trust. The maximum amount of undiscounted future payments the Company could make under the guarantee is approximately $56.6 million, consisting of annual dividend payments of approximately $1.1 million until maturity and the redemption value of the preferred securities of $30.0 million. Because payment under the guarantee would only be required if the Company does not fulfill its obligations under the debentures held by the Issuer Trust, the Company has not recorded any additional liabilities related to this guarantee.

The junior subordinated debenture bears interest at a rate of LIBOR plus 337.5 basis points and matures in April 2034. As of September 30, 2010 and 2009, the interest rate on the junior subordinated debenture was 3.751% and 3.815%, respectively.

7. Employee Benefits

Western Surety sponsors two postretirement benefit plans covering certain employees. One plan provides medical benefits and the other plan provides sick leave termination payments. The medical benefit plan provides coverage for employees, and their eligible dependents, hired by Western Surety before November 1, 1992 and who retire at age 55 or later with at least 15 years of service. Only employees hired by Western Surety prior to 1988 are eligible for the sick leave plan. Further, benefits for the sick leave plan are based on unused accrued sick leave as of December 31, 2003, the date the accruals were frozen. The postretirement medical benefit plan is contributory and the sick leave plan is non-contributory. Western Surety uses a December 31 measurement date for both of its postretirement benefit plans. There were no plan assets for either of the postretirement benefit plans at September 30, 2010 or December 31, 2009.

The postretirement benefit plan that provides medical benefits has been determined to be actuarially equivalent to Medicare Part D on an estimated basis under the rules provided in final regulations issued in 2005. As such, the federal subsidy to plan sponsors under the Medicare Modernization Act (MMA) has been recognized in the accounting for that plan. Also, as further described in Note 9., Income Taxes, to these Condensed Consolidated Financial Statements, enactment of the Patient Protection and Affordable Care Act (the Act) and the Healthcare and Education Affordability Reconciliation Act (the Reconciliation Measure), which modifies certain provisions of the Act, repeal the current rule permitting deduction, for tax purposes, of the entire cost of providing prescription drug benefits even though a portion is offset by the federal subsidy. The impact of these provisions has been recognized in the accounting for this postretirement benefit plan.

The plans combined net periodic postretirement benefit cost included the following components (amounts in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Net periodic benefit cost:				
Service cost	$ 45	$ 65	$ 167	$ 171
Interest cost	147	160	463	429
Amortization of prior service cost (benefit)	(28)	(40)	(83)	(121)
Net amortization of actuarial (gain) loss	(1)			
Net periodic benefit cost	$ 163	$ 185	$ 547	$ 479

The Company expects to contribute $0.2 million to the postretirement benefit plans to pay benefits in 2010. As of September 30, 2010, $0.1 million of contributions have been made to the postretirement benefit plans.

8. Commitments and Contingencies

The Company is party to various lawsuits arising in the normal course of business. The Company believes the resolution of these lawsuits will not have a material adverse effect on its financial condition or its results of operations.

9. Income Taxes

As previously discussed, the enactment of the Act and the related Reconciliation Measure repealed the rule permitting deduction, for tax purposes, of the entire cost of providing prescription drug benefits even though a portion is offset by a federal subsidy. The Company s postretirement benefit plan that provides medical benefits includes such prescription drug coverage. Under the Act and the Reconciliation Measure, the subsidy remains tax-free through 2012.

At March 31, 2010, the impact of these provisions was recognized in the accounting for this postretirement benefit plan. The impact included recognition of additional income tax expense of $0.5 million for the three months ended March 31, 2010.

The Company is subject to taxation in the United States and various state jurisdictions. The Company s tax years 2007 through 2009 remain open as to the applicable statute of limitations and are subject to examination by the Internal Revenue Service.

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The Company has not recognized any liabilities for uncertain income taxes as of September 30, 2010 or December 31, 2009, respectively. Also, the Company does not anticipate any material change in the total amount of unrecognized tax benefits to occur within the next twelve months.

10. Stockholders Equity

The compensation expense recorded for the Company s stock-based compensation plan was $0.4 million for both the three months ended September 30, 2010 and 2009, respectively, and $1.3 million and $1.4 million for the nine months ended September 30, 2010 and 2009, respectively. The total income tax benefit recognized in the Condensed Consolidated Statements of Income for stock-based compensation arrangements was $0.2 million for both the three months ended September 30, 2010 and 2009, respectively. The total income tax benefit recognized in the Condensed Consolidated Statements of Income for stock-based compensation was $0.5 million for both the nine months ended September 30, 2010 and 2009, respectively. The amount of cash received from the exercise of stock options was $0.3 million and $0.1 million for the three months ended September 30, 2010 and 2009, respectively. For the nine months ended September 30, 2010 and 2009, the amount of cash received was $0.8 million and $1.2 million, respectively.

Equity Compensation Plans

The Company reserved shares of its common stock for issuance to directors, officers, employees and certain advisors of the Company through incentive stock options, nonqualified stock options, restricted stock, bonus shares or stock appreciation rights to be granted under the CNA Surety 2006 Long-Term Equity Compensation Plan (the 2006 Plan), approved by shareholders on April 25, 2006. The aggregate number of shares initially available for which options may be granted under the 2006 Plan was 3,000,000. Option exercises under the 2006 Plan are settled in newly issued common shares.

The 2006 Plan is administered by the compensation committee of the Board of Directors (the Committee), consisting of two or more directors of the Company. Subject to the provisions set forth in the 2006 Plan, all of the members of the Committee shall be independent members of the Board of Directors. The Committee determines the option exercise prices. Exercise prices may not be less than the fair market value of the Company s common stock on the date of grant for incentive stock options and may not be less than the par value of the Company s common stock for nonqualified stock options.

The 2006 Plan provides for the granting of incentive stock options as defined under Section 409A of the Internal Revenue Code of 1986, as amended. All nonqualified stock options and incentive stock options granted under the 2006 Plan expire ten years after the date of grant and vest ratably over the four-year period following the date of grant.

On February 5, 2010, 281,260 options were granted under the 2006 Plan. The fair market value (at grant date) per option granted was $7.25 for these options. The fair value of these options was estimated at the grant date using a Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate of 2.32%; dividend yield of 0.0%; expected option life of 5.3 years and volatility of 55.5%, which was based on historical volatility. The Company estimated the expected option life of the 2010 grant based on its analysis of past exercise patterns for similar options. As of September 30, 2010, the number of shares available for granting of options under the 2006 Plan was 1,991,395.

On February 6, 2009, 217,960 options were granted under the 2006 Plan. The fair market value (at grant date) per option granted was $8.95 for these options. The fair value of these options was estimated at the grant date using a Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate of 1.95%; dividend yield of 0.0%; expected option life of 5.3 years and volatility of 51.8%, which was based on historical volatility. The Company estimated the expected option life of the 2009 grant based on its analysis of past exercise patterns for similar options. As of September 30, 2009, the number of shares available for granting of options under the 2006 Plan was 2,247,180.

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A summary of option activity for the nine months ended September 30, 2010 and 2009 is presented below:

	Shares Subject To Option	Weighted Average Exercise Price Per Share
Outstanding options at January 1, 2009	1,221,118	$ 14.93
Options granted	217,960	$ 18.85
Options forfeited	(10,900)	$ 17.63
Options expired	(13,270)	$ 14.34
Options exercised	(89,905)	$ 11.51
Outstanding options at September 30, 2009	1,325,003	$ 15.79
Outstanding options at January 1, 2010	1,318,288	$ 15.78
Options granted	281,260	$ 14.32
Options forfeited	(14,005)	$ 17.30
Options expired	(5,355)	$ 20.05
Options exercised	(57,746)	$ 12.58
Outstanding options at September 30, 2010	1,522,442	$ 15.60

A summary of the status of the Company s non-vested options as of September 30, 2010 and 2009 and changes during the nine months then ended is presented below:

	Shares Subject To Option	Weighted Average Grant Date Fair Value
Non-vested options at January 1, 2009	545,095	$ 7.29
Options granted	217,960	$ 8.95
Options vested	(136,849)	$ 7.82
Options forfeited	(10,900)	$ 7.43
Non-vested options at September 30, 2009	615,306	$ 7.76
Non-vested options at January 1, 2010	539,396	$ 8.10
Options granted	281,260	$ 7.25
Options vested	(185,202)	$ 8.14
Options forfeited	(14,005)	$ 7.84
Non-vested options at September 30, 2010	621,449	$ 7.71

A summary of the options vested or expected to vest and options exercisable as of September 30, 2010 is presented below:

Options Vested or Expected to Vest

	Number	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
September 30, 2010	1,452,476	$ 15.55	$ 4,389,302	6.4 years

	Options Exercisable			
	Number	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
September 30, 2010	900,993	$ 14.93	$ 3,340,444	5.2 years

The total intrinsic value of options exercised was $0.1 million for the three months ended September 30, 2010 and less than $0.1 million for the three months ended September 30, 2009. The total intrinsic value of options exercised was $0.3 million and $0.5 million for the nine months ended September 30, 2010 and 2009, respectively. The tax benefits recognized by the Company for these exercises were less than $0.1 million for the three months ended September 30, 2010 and $0.1 million for the three months ended September 30, 2009. The tax benefits recognized by the Company for these exercises were $0.1 million and $0.2 million for the nine months ended September 30, 2010 and 2009, respectively.

As of September 30, 2010, there was $1.8 million of total unrecognized compensation cost related to non-vested stock-based compensation arrangements granted under the Company s equity compensation plans. That cost is expected to be recognized as follows: 2010 $0.4 million; 2011 $0.9 million; 2012 $0.4 million and 2013 $0.1 million.

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CNA SURETY CORPORATION AND SUBSIDIARIES

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

General

The following is a discussion and analysis of CNA Surety Corporation and its subsidiaries (collectively, CNA Surety or the Company) operating results, liquidity and capital resources and financial condition. This discussion should be read in conjunction with the Condensed Consolidated Financial Statements in Item 1 of Part 1 of this Quarterly Report on Form 10-Q and the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

Critical Accounting Policies

The Company s accounting policies related to reserves and disclosures for unpaid losses and loss adjustment expenses and related estimates of reinsurance recoverables are particularly critical to an assessment of the Company s financial results. Given the nature of the surety business, the determination of these balances is inherently a highly subjective exercise which requires management to analyze, weigh and balance numerous macroeconomic, customer specific and claim specific factors and trends, most of which, in and of themselves, are inherently uncertain and difficult to predict. In addition, management believes the other most critical accounting policies and related disclosures for purposes of understanding the Company s results of operations and financial condition pertain to investments, goodwill and other intangible assets, recognition of premium revenue and the related unearned premium liability and deferred policy acquisition costs.

Reserves for Unpaid Losses and Loss Adjustment Expenses and Reinsurance

CNA Surety accrues liabilities for unpaid losses and loss adjustment expenses (LAE) under its surety and property and casualty insurance contracts based upon estimates of the ultimate amounts payable under the contracts related to losses occurring on or before the balance sheet date.

Reported claims are in various stages of the settlement process. Due to the nature of surety, which is the relationship among three parties whereby the surety guarantees the performance of the principal to a third party (the obligee), the investigation of claims and the establishment of case estimates on claim files can be a complex process that can occur over a period of time depending on the type of bond(s) and the facts and circumstances involving the particular bond(s), the claim(s) and the principal. Case reserves are typically established after a claim is filed and an investigation and analysis has been conducted as to the validity of the claim, the principal s response to the claim and the principal s financial viability. To the extent it is determined that there are no bona fide defenses to the claim and the principal is unwilling or financially unable to resolve the claim, a case reserve is established on the claim file for the amount the Company estimates it will have to pay to honor its obligations under the provisions of the bond(s).

While the Company intends to establish initial case reserve estimates that are sufficient to cover the ultimate anticipated loss on a claim file, some estimates need to be adjusted during the life cycle of the claim file as matters continue to develop. Factors that can necessitate case reserve increases or decreases are the complexity of the bond(s) and/or underlying contract(s), if additional and/or unexpected claims are filed, if the financial condition of the principal or obligee changes or as claims develop and more information is discovered that was unknown and/or unexpected at the time the initial case reserve estimate was established. Ultimately, claims are resolved through payment and/or a determination that, based on the information available, a case reserve is no longer required.

As of any balance sheet date, not all claims have been reported and some claims may not be reported for many years. As a result, the liability for unpaid losses includes significant estimates for incurred-but-not-reported (IBNR) claims. The IBNR reserves also include provisions for losses in excess of the current case reserve for previously reported claims and for claims that may be reopened. The IBNR reserves also include offsets for anticipated indemnity recoveries.

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The following table shows the estimated liability as of September 30, 2010 for unpaid claims applicable to reported claims and to IBNR for each sub-line of business (dollars in thousands):

	Gross Case Loss and LAE Reserves	Gross IBNR Loss and LAE Reserves	Total Gross Reserves
Contract	$ 76,981	$ 240,687	$ 317,668
Commercial	50,052	60,800	110,852
Fidelity and other	3,983	7,440	11,423
Total	$ 131,016	$ 308,927	$ 439,943

Periodic actuarial analyses of the Company s loss reserves are performed. These analyses include a comprehensive review performed in the fourth quarter based on data as of September 30 and an update of the comprehensive review performed in January based on data as of December 31. In between these analyses, management monitors claim activity against benchmarks of expected claim activity prepared in connection with the comprehensive review and records adjustments as necessary.

The actuarial analysis is the primary tool that management utilizes in determining its best estimate of loss reserves. However, the carried reserve may differ from the actuarial point estimate as a result of management s consideration of the impact of factors such as the following, especially as they relate to the current accident year:

Current claim activity, including the frequency and severity of current claims;

Changes in underwriting standards and business mix such as the Company s efforts to reduce exposures to large commercial bonds;

Changes in the claims handling process;

Potential changes in the Company s reinsurance program; and

Current economic conditions, especially corporate default rates and the condition of the construction economy.

Management believes that the impact of the factors listed above, and others, may not be fully quantifiable through actuarial analysis. Accordingly, management applies its judgment of the impact of these factors, and others, to its selection of the recorded loss reserves.

Receivables recorded with respect to insurance losses ceded to reinsurers under reinsurance contracts are estimated in a manner similar to liabilities for insurance losses and, therefore, are also subject to uncertainty. In addition to the factors cited above, assumptions are made regarding the impact of reinsurance programs to be in place in future periods. Estimates of reinsurance recoveries may prove uncollectible if the reinsurer is unable to perform under the contract. Reinsurance contracts do not relieve the ceding company of its obligations to indemnify its own policyholders.

Casualty insurance loss reserves are subject to a significant amount of uncertainty. Given the nature of surety losses with its low frequency, high severity characteristics, this is particularly true for surety loss reserves. As a result, the range of reasonable loss reserve estimates may be broader than that associated with traditional property/casualty insurance products. While the loss reserve estimates represent the best professional judgments, arrived at after careful actuarial analysis of the available data, it is important to note that variation from the estimates is not only possible but, in fact, probable. The sources of this inherent variability are numerous future economic conditions, court decisions, legislative actions and individual large claim impacts, for example.

Due to the inherent uncertainties in the process of establishing the liabilities for unpaid losses and loss adjustment expenses, the actual ultimate claims amounts will differ from the currently recorded amounts. This difference could have a material effect on reported earnings and financial condition. Future effects from changes in these estimates will be recorded in the period such changes are determined to be needed.

Investments

Management believes the Company has the ability to hold all fixed income securities to maturity. However, the Company may dispose of securities prior to their scheduled maturity due to changes in interest rates, prepayments, tax and credit considerations, liquidity or regulatory capital requirements, or other similar factors. As a result, the Company considers all of its fixed income securities (bonds) and equity securities as available-for-sale. These securities are reported at fair value, with unrealized gains and losses, net of deferred income taxes, reported in stockholders equity as a separate component of accumulated other comprehensive income.

Fixed income securities in an unrealized loss position that the Company intends to sell, or it more likely than not will be required to sell before recovery of amortized cost, are considered to be other-than-temporarily impaired (OTTI). These securities are written down to fair value and the resulting losses are recognized in realized gains/losses in the Condensed Consolidated Statements of Income. Fixed income securities in an unrealized loss position for which management believes a credit loss exists are also considered to be other-than-temporarily impaired. For those securities, the Company bifurcates the impairment into a credit component and a non-credit component. The credit component, which represents the difference between discounted expected cash flows and the fixed income security s amortized cost, is recognized in earnings and the non-credit component is recognized in other comprehensive income. Cash flows from purchases, sales and maturities of fixed income and equity securities are reported gross in the investing activities section of the Condensed Consolidated Statements of Cash Flows.

The amortized cost of fixed income securities is determined based on cost, adjustments for previously recorded OTTI losses and the cumulative effect of amortization of premiums and accretion of discounts using the interest method. Such amortization and accretion are included in investment income. For mortgage-backed and asset-backed securities, the Company considers estimates of future prepayments in the calculation of the effective yield used to apply the interest method. If a difference arises between the anticipated prepayments and the actual prepayments, the Company recalculates the effective yield based on actual prepayments and the currently anticipated future prepayments. The amortized costs of such securities are adjusted to the amount that would have resulted had the recalculated effective yields been applied since the acquisition of the securities with a corresponding charge or credit to investment income. Prepayment estimates are based on the structural elements of specific securities, interest rates and generally recognized prepayment speed indices.

Short-term investments, that generally include U.S. Treasury bills, corporate notes, money market funds and investment grade commercial paper equivalents, are carried at amortized cost, which approximates fair value.

Invested assets are exposed to various risks, such as interest rate risk, market risk and credit risk. Due to the level of risk associated with invested assets and the level of uncertainty related to changes in the value of these assets, it is possible that changes in risks in the near term may materially affect the amounts reported in the Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Income.

Goodwill and Other Intangible Assets

CNA Surety s Condensed Consolidated Balance Sheets as of September 30, 2010 and December 31, 2009 include goodwill and intangible assets of approximately $138.8 million. This amount primarily represents goodwill and identified intangibles with indefinite useful lives arising from the acquisition of Capsure Holdings Corp.

A significant amount of judgment is required in performing intangible assets impairment tests. Such tests include periodically determining or reviewing the estimated fair value of CNA Surety s reporting units. Under the relevant standard, fair value of a reporting unit refers to the price that would be received to sell the reporting unit as a whole in an orderly transaction between market participants. There are several methods of estimating fair value, including market quotations, asset and liability fair values and other valuation techniques, such as discounted cash flows and multiples of earnings or revenues. The Company uses a valuation technique based on discounted cash flows. Significant inputs to the Company s discounted cash flow model include estimated capital requirements to support the business, expected cash flows from underwriting activity, required capital reinvestment to support growth and the selected discount rates. If the carrying amount of a reporting unit, including goodwill, exceeds the estimated fair value, then individual assets, including identifiable intangible assets, and liabilities of the reporting unit are estimated at fair value. The excess of the estimated fair value of the reporting unit over the estimated fair value of net assets would establish the implied value of intangible assets. The excess of the recorded amount of intangible assets over the implied value of intangible assets is recorded as an impairment loss.

Insurance Premiums

Insurance premiums are recognized as revenue ratably over the term of the related policies in proportion to the insurance protection provided. Contract bonds provide coverage for the length of the bonded project and not a fixed time period. As such, the Company uses estimates of the contract length as the basis for recognizing premium revenue on these bonds. Premium revenues are net of amounts ceded to reinsurers. Unearned premiums represent the portion of premiums written, before ceded reinsurance which is shown as an asset, applicable to the unexpired terms of policies in force determined on a pro rata basis.

Insurance premium receivables are presented net of an estimated allowance for doubtful accounts, which is based on a periodic evaluation of the aging and collectability of premium receivables.

Deferred Policy Acquisitions Costs

Policy acquisition costs, consisting of commissions, premium taxes and other underwriting expenses which vary with, and are primarily related to, the production of business, net of reinsurance commissions, are deferred and amortized as a charge to income as the related premiums are earned. The Company periodically tests that deferred policy acquisition costs are recoverable based on the expected profitability embedded in the reserve for unearned premium. If the expected profitability is less than the balance of deferred policy acquisition costs, a charge to net income is taken and the deferred policy acquisition cost balance is reduced to the amount determined to be recoverable. Anticipated investment income is considered in the determination of the recoverability of deferred policy acquisition costs.

Results of Operations

Financial Measures

The Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) discusses certain accounting principles generally accepted in the United States of America (GAAP) and non-GAAP financial measures in order to provide information used by management to monitor the Company s operating performance. Management utilizes various financial measures to monitor the Company s insurance operations and investment portfolio. Underwriting results, which are derived from certain income statement amounts, are considered a non-GAAP financial measure and are used by management to monitor performance of the Company s insurance operations.

Underwriting results are computed as net earned premiums less net losses and loss adjustment expenses and net commissions, brokerage and other underwriting expenses. Management uses underwriting results to monitor its insurance operations results without the impact of certain factors, including net investment income, net realized investment gains (losses) and interest expense. Management excludes these factors in order to analyze the direct relationship between net earned premiums and the related net losses and loss adjustment expenses along with net commissions, brokerage and other underwriting expenses.

Operating ratios are calculated using insurance results and are widely used by the insurance industry and regulators such as state departments of insurance and the National Association of Insurance Commissioners for financial regulation and as a basis of comparison among companies. The ratios discussed in the Company s MD&A are calculated using GAAP financial results and include the net loss and loss adjustment expense ratio (loss ratio) as well as the net commissions, brokerage and other underwriting expense ratio (expense ratio) and combined ratio. The loss ratio is the percentage of net incurred losses and loss adjustment expenses to net earned premiums. The expense ratio is the percentage of net commissions, brokerage and other underwriting expenses, including the amortization of deferred policy acquisition costs, to net earned premiums. The combined ratio is the sum of the loss ratio and expense ratio.

While management uses various GAAP and non-GAAP financial measures to monitor various aspects of the Company s performance, net income is the most directly comparable GAAP measure and represents a more comprehensive measure of operating performance. Management believes that its process of evaluating performance through the use of these non-GAAP financial measures provides a basis for enhanced understanding of the operating performance and the impact to net income as a whole. Management also believes that investors may find these widely used financial measures described above useful in interpreting the underlying trends and performance, as well as to provide visibility into the significant components of net income.

Comparison of CNA Surety Actual Results for the Three and Nine Months Ended September 30, 2010 and 2009

Analysis of Net Income

Net income for the three months ended September 30, 2010 was $30.5 million, or $0.69 per diluted share, compared to $25.5 million, or $0.57 per diluted share, for the same period in 2009. The increase in net income primarily reflects the impact of higher net favorable loss reserve development in the 2010 period and lower net commissions, brokerage and other underwriting expenses compared to the 2009 period.

Net income for the nine months ended September 30, 2010 was $79.9 million, or $1.80 per diluted share, compared to $68.6 million, or $1.54 per diluted share, in 2009. The increase in net income reflects the impact of higher net favorable loss reserve development, higher net investment income and lower net commissions, brokerage and other underwriting expenses, partially offset by lower net earned premium.

The components of net income are discussed in the following sections.

Results of Insurance Operations

Underwriting components for the Company for the three and nine months ended September 30, 2010 and 2009 are summarized in the following table (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Gross written premiums	$ 113,784	$ 113,402	$ 341,258	$ 341,361
Net written premiums	$ 107,705	$ 106,361	$ 323,109	$ 320,495
Net earned premiums	$ 110,275	$ 109,703	$ 313,741	$ 316,549
Net losses and loss adjustment expenses	$ 19,095	$ 24,429	$ 69,272	$ 84,992
Net commissions, brokerage and other underwriting expenses	$ 59,609	$ 62,169	$ 168,202	$ 172,364
Loss ratio	17.3%	22.3%	22.1%	26.8%
Expense ratio	54.1	56.7	53.6	54.5
Combined ratio	71.4%	79.0%	75.7%	81.3%

Premiums Written/Earned

CNA Surety primarily markets contract and commercial surety bonds. Contract surety bonds generally secure a contractor s performance and/or payment obligation with respect to a construction project. Contract surety bonds are generally required by federal, state and local governments for public works projects. The most common types include bid, performance and payment bonds. Commercial surety bonds include all surety bonds other than contract and cover obligations typically required by law or regulation. The commercial surety market includes numerous types of bonds categorized as court judicial, court fiduciary, public official, license and permit and many miscellaneous bonds that include guarantees of financial performance. The Company also writes fidelity bonds that cover losses arising from employee dishonesty and other insurance products that are generally companion products to certain surety bonds. For example, the Company writes surety bonds for notaries and also offers related errors and omissions insurance coverage.

Through one of its insurance subsidiaries, Western Surety Company (Western Surety), the Company assumes significant amounts of premiums primarily from affiliates. This includes surety business written or renewed, net of reinsurance, by Continental Casualty Company (CCC) and The Continental Insurance Company (CIC), and their affiliates, after September 30, 1997 that is reinsured by Western Surety pursuant to reinsurance and related agreements. Because of certain regulatory restrictions that limit the Company s ability to write certain business on a direct basis, the Company continues to utilize the underwriting capacity available through these agreements. The Company is in full control of all aspects of the underwriting and claim management of the assumed business from CCC and CIC.

CNA Surety also assumes premium on contract and commercial surety bonds for international risks. Such premiums are assumed pursuant to the terms of reinsurance treaties or as a result of specific international bond requirements of domestic customers. For the three month periods ended September 30, 2010 and 2009, assumed premiums written under such arrangements were $0.7 million and $0.9 million, respectively. For the nine months ended September 30, 2010 and 2009, assumed premiums written under such arrangements were $3.3 million and $1.8 million, respectively.

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Gross written premium, which is the aggregate of direct written premiums and assumed written premiums, for the three months and nine months ended September 30, 2010 and 2009 is shown in the table below (dollars in thousands) for each sub-line of business:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Contract	$ 73,653	$ 71,817	$ 217,002	$ 215,301
Commercial	32,616	34,163	100,459	102,579
Fidelity and other	7,515	7,422	23,797	23,481
	$ 113,784	$ 113,402	$ 341,258	$ 341,361

For the three months ended September 30, 2010, gross written premiums increased 0.3 percent to $113.8 million compared to $113.4 million for the three months ended September 30, 2009. Contract surety gross written premiums increased 2.6 percent to $73.7 million despite continued challenges in the construction industry. Commercial surety written premiums decreased 4.5 percent to $32.6 million due to a modest decline in the small commercial market, partially offset by selective growth in the corporate commercial market.

For the nine months ended September 30, 2010, gross written premiums decreased slightly to $341.3 million compared to $341.4 million for the nine months ended September 30, 2009. Gross written premiums for contract surety increased 0.8 percent to $217.0 million despite continued challenges in the construction industry. Commercial surety gross written premiums decreased 2.1 percent to $100.5 million due to a modest decline in the small commercial market, partially offset by selective growth in the corporate commercial market.

The Company s insurance subsidiaries purchase reinsurance from other insurance companies and affiliates. Reinsurance arrangements are used to limit maximum loss, provide greater diversification of risk and minimize exposure on larger risks. The cost of this reinsurance is recorded as ceded written premium. The lower cost of the Company s 2010 third party excess of loss treaty decreased ceded written premium by $1.0 million to $6.0 million for the three months ended September 30, 2010 and by $2.7 million to $18.1 million for the nine months ended September 30, 2010 as compared to the same periods in 2009.

Net written premium, which is gross written premiums less ceded written premiums, for the three and nine months ended September 30, 2010 and 2009 are shown in the table below (dollars in thousands) for each sub-line of business:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Contract	$ 68,310	$ 65,674	$ 201,047	$ 196,826
Commercial	31,880	33,265	98,265	100,188
Fidelity and other	7,515	7,422	23,797	23,481
	$ 107,705	$ 106,361	$ 323,109	$ 320,495

For the three months ended September 30, 2010, net written premiums increased 1.3 percent to $107.7 million compared to $106.4 million for the three months ended September 30, 2009 primarily due to lower ceded written premium.

Net written premiums for the nine months ended September 30, 2010 increased 0.8 percent to $323.1 million compared to $320.5 million for the nine months ended September 30, 2009 due to lower ceded written premium.

Net written premiums are recognized as revenue over the policy term as net earned premiums. Net earned premiums for the three months and nine months ended September 30, 2010 and 2009 are shown in the table below (dollars in thousands) for each sub-line of business:

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Contract	$ 69,852	$ 68,815	$ 193,388	$ 195,314
Commercial	32,781	33,208	97,699	98,246
Fidelity and other	7,642	7,680	22,654	22,989
	$ 110,275	$ 109,703	$ 313,741	$ 316,549

For the three months ended September 30, 2010, net earned premiums increased 0.5 percent to $110.3 million compared to $109.7 million for the three months ended September 30, 2009. For the nine months ended September 30, 2010, net earned premiums decreased 0.9 percent to $313.7 million, primarily due to the decrease in gross written premiums discussed above.

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Net Loss Ratio

The net loss ratio was 17.3% for the three months ended September 30, 2010 compared with 22.3% for the same period in 2009. The net loss ratio was 22.1% for the nine months ended September 30, 2010 compared with 26.8% for the same period in 2009. These loss ratios include re-estimates of prior accident year reserves, known as reserve development. The dollar amount and percentage point effect of these reserve reductions were $13.0 million, or 11.8 percentage points, and $7.9 million, or 7.1 percentage points, for the three months ended September 30, 2010 and 2009, respectively. The dollar amount and percentage point effect of these revisions were reductions of $22.0 million, or 7.0 percentage points, and $7.9 million, or 2.6 percentage points, for the nine months ended September 30, 2010 and 2009, respectively.

Expense Ratio

The expense ratio was 54.1% and 53.6% for the three months and nine months ended September 30, 2010 as compared with 56.7% and 54.5% for the same periods in 2009, respectively. Expenses for the three and nine months ended September 30, 2010 included the impact of increased accruals in the three months ended September 30, 2010 for incentive compensation based on the results for the nine months ended September 30, 2010. The expense ratios for the three months and nine months ended September 30, 2009 included impairments of capitalized software development costs related to in-development projects that the Company terminated. These impairments totaled $4.9 million, which added 4.5 and 1.6 percentage points to the expense ratio for the three and nine months ended September 30, 2009, respectively.

Investment Income and Realized Investment Gains/Losses

Net investment income for the three months ended September 30, 2010 was $13.5 million compared to $12.5 million during the three months ended September 30, 2009 due to an increase in invested assets, partially offset by lower yields. The annualized pre-tax yields were 3.9% and 4.1% for the three months ended September 30, 2010 and 2009, respectively. The annualized after-tax yields were 3.2% and 3.4% for the three months ended September 30, 2010 and 2009, respectively.

Net investment income for the nine months ended September 30, 2010 was $39.6 million compared to $37.4 million for the same period in 2009. The increase reflects the impact of higher overall invested assets, partially offset by lower yields. The annualized pre-tax yields were 4.0% and 4.2% for the nine months ended September 30, 2010 and 2009, respectively. The annualized after-tax yields were 3.3% and 3.5% for the nine months ended September 30, 2010 and 2009, respectively.

The following summarizes net realized investment gains (losses) activity (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Net realized investment gains (losses):				
Fixed income securities:				
Gross realized investment gains	$ 4	$ 1,448	$ 1,197	$ 1,491
Gross realized investment losses:				
Other-than-temporary impairment losses			(122)	(116)
Realized losses from sales	(5)	(392)	(26)	(392)
Total gross realized investment losses	(5)	(392)	(148)	(508)
Net realized investment (losses) gains on fixed income securities	(1)	1,056	1,049	983
Equity securities:				
Gross realized investment gains	8		20	27

Gross realized investment losses:				
Other-than-temporary impairment losses				(46)
Realized losses from sales				(20)
Total gross realized investment losses				(66)
Net realized investment gains (losses) on equity securities	8		20	(39)
Other	1			(1)
Net realized investment gains	$ 8	$ 1,056	$ 1,069	$ 943

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The Company s investment portfolio is generally managed to maximize after-tax investment return, while minimizing credit risk with investments concentrated in high quality fixed income securities. CNA Surety s portfolio is managed to provide diversification by limiting exposures to any one industry, issue or issuer, and to provide liquidity by investing in the public securities markets. The portfolio is structured to support CNA Surety s insurance underwriting operations and to consider the expected duration of liabilities and short-term cash needs. In achieving these goals, assets may be sold to take advantage of market conditions or other investment opportunities or regulatory, credit and tax considerations. These activities will produce realized gains and losses.

Interest Expense

The benchmark interest rate for the Company s variable interest rate debt is the London Interbank Offered Rate (LIBOR). Due to lower three-month LIBOR rates, interest expense decreased by 6.3 percent and 20.5 percent for the three and nine months ended September 30, 2010, respectively, as compared with the same periods in 2009. Weighted average debt outstanding was $30.9 million for each of these periods. The weighted average interest rate for the three months ended September 30, 2010 was 3.8% as compared with 4.0% for the same period in 2009. The weighted average interest rate for the nine months ended September 30, 2009 was 3.7% as compared with 4.5% for the same period in 2009.

Income Taxes

The Company s income tax expense was $14.3 million and $36.2 million for the three and nine months ended September 30, 2010, respectively. The Company s income tax expense was $10.9 million and $27.8 million for the three and nine months ended September 30, 2009, respectively. The effective income tax rates for the three and nine months ended September 30, 2010 were 31.9% and 31.2%, respectively. The effective income tax rates for the three and nine months ended September 30, 2009 were 29.8% and 28.9%, respectively. The Company s effective tax rate differs from the statutory tax rate due primarily to tax-exempt investment income. Tax-exempt investment income was $6.3 million and $18.4 million for the three and nine months ended September 30, 2010, respectively. Tax-exempt investment income was $6.1 million and $19.2 million for the three and nine months ended September 30, 2009, respectively.

Exposure Management

The Company s business is subject to certain risks and uncertainties associated with the current economic environment and corporate credit conditions. In response to these risks and uncertainties, the Company has enacted various exposure management initiatives. With respect to risks on large commercial accounts, the Company generally limits its exposure to $25.0 million per account, but will selectively accept higher exposures.

With respect to contract surety, the Company s portfolio is predominantly comprised of contractors with bonded backlog of less than $30.0 million. Bonded backlog is an estimate of the Company s exposure in the event of default before indemnification. The Company does have accounts with bonded backlogs greater than $30.0 million.

The Company manages its exposure to any one contract credit and aggressively looks for co-surety, shared accounts and other means to support or reduce larger exposures. Reinsurance and indemnification rights, including rights to contract proceeds on construction projects in the event of default, exist that substantially reduce CNA Surety s exposure to loss.

Excess of Loss Reinsurance

The Company s ceded reinsurance program is predominantly comprised of excess of loss reinsurance contracts that limit the Company s retention on a per principal basis. The Company s reinsurance coverage is provided by third party reinsurers and related parties. Due to the terms of these excess of loss treaties, reinsurers may cover some principals in one year but then exclude these same principals in subsequent years. As a result, the Company may have exposures to these principals that have limited or no reinsurance coverage. Only the large national contractor discussed below was excluded from the third party reinsurance agreements effective for the treaty periods discussed; however, as discussed below, the Company has no further exposure to this principal.

2009 Third Party Reinsurance

Effective January 1, 2009, CNA Surety entered into an excess of loss treaty (2009 Excess of Loss Treaty) with a group of third party reinsurers on terms similar to the excess of loss treaty effective in 2008. Under the 2009 Excess of Loss Treaty, the Company s net retention per principal was $15 million with a 5% co-participation in the $90 million layer of third party reinsurance coverage

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above the Company s retention. The contract provided aggregate coverage of $185 million and included an optional extended discovery period, which was not exercised. The contract also included a provision for additional premiums of up to $13.8 million based on losses ceded under the contract. The actual ceded premiums for the 2009 Excess of Loss Treaty were $26.6 million.

2010 Third Party Reinsurance

Effective January 1, 2010, CNA Surety entered into an excess of loss treaty (2010 Excess of Loss Treaty) with a group of third party reinsurers on terms similar to the 2009 Excess of Loss Treaty. Under the 2010 Excess of Loss Treaty, the Company s net retention per principal remains at $15 million with a 5% co-participation in the $90 million layer of third party reinsurance coverage above the Company s retention. The contract provides aggregate coverage of $185 million and includes an optional extended discovery period, for an additional premium (a percentage of the original premium based on any unexhausted aggregate limit by layer), which will provide coverage for losses discovered beyond 2010 on bonds that were in force during 2010. The contract also includes a provision for additional premiums of up to $12.3 million based on losses ceded under the contract. The base annual premium for the 2010 Excess of Loss Treaty is $24.6 million.

Related Party Reinsurance

Reinsurance agreements together with the Services and Indemnity Agreement described below provide for the transfer of the surety business written by CCC and CIC to Western Surety. Many of these agreements originally were entered into on September 30, 1997 (the Merger Date) and include: (i) the Surety Quota Share Treaty (the Quota Share Treaty); (ii) the Aggregate Stop Loss Reinsurance Contract (the Stop Loss Contract) and (iii) the Surety Excess of Loss Reinsurance Contract. Although the contracts entered on the Merger Date have expired, some have been renewed on different terms as described below.

Through the Quota Share Treaty, CCC and CIC transfer to Western Surety surety business written or renewed by CCC and CIC after the Merger Date. The Quota Share Treaty was renewed on January 1, 2010 and expires on December 31, 2010 and is annually renewable thereafter. CCC and CIC transfer the related liabilities of such business and pay to Western Surety an amount in cash equal to CCC s and CIC s net written premiums written on all such business, minus a quarterly ceding commission to be retained by CCC and CIC equal to $50,000 plus 25% of net written premiums written on all such business. For 2009 this resulted in an override commission on their actual direct acquisition costs of 4.8% to CCC and CIC.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of the Merger Date by agreeing to pay Western Surety, within 30 days following the end of each calendar quarter, the amount of any adverse development on such reserves, as re-estimated as of the end of such calendar quarter. There was no adverse reserve development for the period from the Merger Date through September 30, 2010.

Through the Stop Loss Contract, the Company s insurance subsidiaries were protected from adverse loss development on certain business underwritten after the Merger Date. The Stop Loss Contract between the Company s insurance subsidiaries and CCC limited the insurance subsidiaries prospective net loss ratios with respect to certain accounts and lines of insured business for three full accident years following the Merger Date. In the event the insurance subsidiaries accident year net loss ratio exceeds 24% in any of the accident years 1997 through 2000 on certain insured accounts (the Loss Ratio Cap), the Stop Loss Contract requires CCC at the end of each calendar quarter following the Merger Date, to pay to the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which the Company s actual accident year net loss ratio exceeds the applicable Loss Ratio Cap, multiplied by (ii) the applicable net earned premiums. In consideration for the coverage provided by the Stop Loss Contract, the Company s insurance subsidiaries paid CCC an annual premium of $20,000. The CNA Surety insurance subsidiaries have paid CCC all required annual premiums. Through September 30, 2010 and December 31, 2009, losses incurred under the Stop Loss Contract were $47.2 million and $49.1 million, respectively. The decrease is due to favorable development on claims subject to the Stop Loss Contract during the three months ended March 31, 2010. At September 30, 2010, the amount received under the Stop Loss Contract included $2.7 million held by the Company for losses covered under this contract that were incurred but not paid.

The Services and Indemnity Agreement provides the Company s insurance subsidiaries with the authority to perform various administrative, management, underwriting and claim functions in order to conduct the surety business of CCC and CIC and to be reimbursed by CCC for services rendered. In consideration for providing the foregoing services, CCC has agreed to pay Western Surety a quarterly fee of $50,000. In 2009, this agreement was amended so that the Company s authority to conduct administrative, management, underwriting and claim functions for bonds written for the large national contractor discussed below shall continue until CCC s bonds for such contractor have expired and claims have been settled or closed. This agreement was renewed on January 1, 2010 and expires on December 31, 2010 and is annually renewable thereafter. As of September 30, 2010 there were no amounts due to the CNA Surety insurance subsidiaries under this agreement.

From January 1, 2005 to June 30, 2009, the Company and CCC were parties to an excess of loss contract, and extensions to that contract, that provided unlimited reinsurance coverage in excess of $60 million retention for the life of bonds either in force or written during the contract periods exclusively for the one large national contractor excluded from the Company s third party reinsurance. Premiums for these contracts totaled $8.6 million and included an initial premium of $7.0 million and premiums of $1.6 million based on the level of premiums written on bonds for the large national contractor.

In 2009, the Company and CCC terminated the excess of loss contract discussed in the preceding paragraph. Related to the termination of this contract, the Company and CCC also commuted the Quota Share Treaty as regards the premium and losses for the large national contractor. The impact of this commutation was a decrease of gross loss reserves of $51.8 million. Under the terms of the agreements effecting this commutation, the Company paid CCC $1.8 million. This settlement reflected the difference between the Company s $60.0 million retention under the excess of loss contract and the $58.2 million paid by the Company for losses of the large national contractor through 2009.

On January 1, 2010, the Company and CCC entered into separate agreements that provide for the transfer of the Canadian surety business of CCC to Western Surety. These agreements, which include a quota share treaty (the Canadian Quota Share Treaty) and a services and indemnity agreement (the Canadian Services and Indemnity Agreement), are substantially similar to the Quota Share Treaty and the Services and Indemnity Agreement discussed above. The Canadian Services and Indemnity Agreement provides Western Surety with the authority to supervise various administrative, underwriting and claim functions associated with the surety business written by CCC, through its Canadian branch, on behalf of the Company. Through the Canadian Quota Share Treaty, this Canadian surety business is transferred to Western Surety. Pursuant to these agreements, CCC will transfer the subject premium and related liabilities of such business and pay to Western Surety an amount equal to CCC s net written premiums on all such business, minus a ceding commission of 33.5% of net written premiums. Further, Western Surety will pay an additional ceding commission to CCC in the amount of actual direct expense in producing such premium. These agreements expire on December 31, 2010 and are annually renewable thereafter.

As of September 30, 2010 and December 31, 2009, CNA Surety had an insurance receivable balance from CCC and CIC of $10.6 million and $9.8 million, respectively, comprised of premiums receivable. Also, at September 30, 2010, CNA Surety had a receivable of $0.4 million carried in Other assets in the Company s Condensed Consolidated Balance Sheets primarily related to the Administrative Services Agreement with CCC.

The Company s Condensed Consolidated Balance Sheets also include a Deposit with affiliated ceding company of $23.4 million and $26.9 million at September 30, 2010 and December 31, 2009, respectively. In 2005, pursuant to an agreement with the claimant on a bond regarding certain aspects of the claim resolution, the Company deposited $32.7 million with an affiliate to enable the affiliate to establish a trust to fund future payments under the bond. The bond was written by the affiliate and assumed by one of the Company s insurance subsidiaries pursuant to the Quota Share Treaty. The Company is entitled to the interest income earned by the trust. Prior to the establishment of the trust, the Company had fully reserved its obligation under the bond and the claim remains fully reserved.

Liquidity and Capital Resources

It is anticipated that the liquidity requirements of CNA Surety will be met primarily by funds generated from operations. The principal sources of operating cash flows are premiums, investment income and recoveries under reinsurance contracts. The primary cash flow uses are payments for claims, operating expenses, federal income taxes and debt service. In general, surety operations generate premium collections from customers in advance of cash outlays for claims. Premiums are invested until such time as funds are required to pay claims and claims adjusting expenses.

The Company believes that total invested assets, including cash and short-term investments, are sufficient in the aggregate and have suitably scheduled maturities to satisfy all policy claims and other operating liabilities, including dividend and income tax sharing payments of its insurance subsidiaries. If cash requirements unexpectedly exceed cash inflows, the Company may raise additional cash by liquidating fixed income securities ahead of their scheduled maturity. Depending on the interest rate environment at that time, the Company could generate realized gains or losses that would increase or decrease net income for the period. The extent of these gains or losses would depend on a number of factors such as the prevailing interest rates and credit spreads, the duration of the assets sold and the marketability of the assets. The need to liquidate fixed income securities would be expected to cause a reduction in future investment income.

At September 30, 2010, the carrying value of the Company s insurance subsidiaries invested assets was comprised of $1,428.9 million of fixed income securities and $37.7 million of short-term investments and cash. At December 31, 2009, the carrying value of the Company s insurance subsidiaries invested assets was comprised of $1,266.2 million of fixed income securities and $39.8 million of short-term investments and cash.

Cash flow at the parent company level is derived principally from dividend and tax sharing payments from its insurance subsidiaries, and to a lesser extent, investment income. The principal obligations at the parent company level are to service debt and pay operating expenses, including income taxes. At September 30, 2010, the parent company s invested assets consisted of $1.9 million of equity securities and $8.8 million of short-term investments and cash. At December 31, 2009, the parent company s invested assets consisted of $1.6 million of equity securities and $14.0 million of short-term investments and cash. At September 30, 2010 and December 31, 2009, parent company short-term investments and cash included $7.3 million and $11.1 million, respectively, of cash and short-term investments primarily related to premium receipt collections ultimately due to the Company s insurance subsidiaries.

The Company s consolidated net cash flow provided by operating activities was $107.1 million for the nine months ended September 30, 2010 compared to net cash flow provided by operating activities of $109.7 million for the comparable period in 2009. This decrease results from higher federal income tax payments partially offset by lower net loss and loss adjustment expense payments, higher investment income received and lower commissions, brokerage and other underwriting expenses paid.

The Company s consolidated net cash flow provided by operating activities was $41.0 million for the three months ended September 30, 2010 compared to net cash flow provided by operating activities of $44.5 million for the comparable period in 2009. This decrease is due to the factors described above for the nine-month period ended September 30, 2010; however, the impact of higher federal income tax payments and the impact of lower commissions, brokerage and other underwriting expenses paid were significantly less for the three-month period.

In May 2004, the Company, through a wholly-owned trust, privately issued $30.0 million of preferred securities through two pooled transactions. These securities, issued by CNA Surety Capital Trust I (the Issuer Trust), bear interest at LIBOR plus 337.5 basis points with a 30-year term. Beginning in May 2009, these securities may be redeemed, in whole or in part, at par value at any scheduled quarterly interest payment date. As of September 30, 2010, none of these preferred securities have been redeemed.

The Company s investment of $0.9 million in the Issuer Trust is carried at cost in Other assets in the Company s Condensed Consolidated Balance Sheets. The sole asset of the Issuer Trust consists of a $30.9 million junior subordinated debenture issued by the Company to the Issuer Trust. Due to the underlying characteristics of this debt, the carrying value of the debenture approximates its estimated fair value.

The Company has also guaranteed the dividend payments and redemption of the preferred securities issued by the Issuer Trust. The maximum amount of undiscounted future payments the Company could make under the guarantee is approximately $56.6 million, consisting of annual dividend payments of approximately $1.1 million until maturity and the redemption value of the preferred securities of $30.0 million. Because payment under the guarantee would only be required if the Company does not fulfill its obligations under the debentures held by the Issuer Trust, the Company has not recorded any additional liabilities related to this guarantee.

The junior subordinated debenture bears interest at a rate of LIBOR plus 337.5 basis points and matures in April 2034. As of September 30, 2010 and 2009, the interest rate on the junior subordinated debenture was 3.751% and 3.815%, respectively.

The Company does not have any material off-balance sheet arrangements as defined by Item 303 of Regulation S-K under the Securities Act of 1933 and the Securities Exchange Act of 1934.

A summary of the Company s commitments as of September 30, 2010 is presented in the following table (in millions):

Contractual Obligations as of September 30, 2010	2010	2011	2012	2013	2014	Thereafter	Total
Debt [(a)]	$ 0.3	$ 1.2	$ 1.2	$ 1.2	$ 1.2	$ 53.3	$ 58.4
Operating leases	0.5	1.9	1.0	0.1	0.1		3.6
Loss and loss adjustment expense reserves	20.6	130.9	87.5	61.5	56.1	83.3	439.9
Other long-term liabilities [(b)]	0.1	1.6	1.2	0.7	0.4	10.4	14.4
Total	$ 21.5	$ 135.6	$ 90.9	$ 63.5	$ 57.8	$ 147.0	$ 516.3

(a) Reflects expected principal and interest payments.

(b) Reflects unfunded postretirement benefit plans and long-term incentive plan payments to certain executives.

As an insurance holding company, CNA Surety is dependent upon dividends and other permitted payments from its insurance subsidiaries to pay operating expenses and meet debt service requirements, as well as to potentially pay cash dividends. The payment of dividends by the insurance subsidiaries is subject to varying degrees of supervision by the insurance regulatory authorities in the insurance subsidiaries states of domicile. Western Surety, Surety Bonding Company of America (Surety Bonding) and Universal Surety of America (Universal Surety) are domiciled in South Dakota. In South Dakota, insurance companies may only pay dividends from earned surplus excluding surplus arising from unrealized capital gains or revaluation of assets. The insurance subsidiaries may pay dividends without obtaining prior regulatory approval only if such dividend or distribution (together with dividends or distributions made within the preceding 12-month period) is less than, as of the end of the immediately preceding year, the greater of (i) 10% of the insurer s surplus to policyholders or (ii) statutory net income. In South Dakota, net income includes net realized capital gains in an amount not to exceed 20% of net unrealized capital gains. All dividends must be reported to the South Dakota Division of Insurance prior to payment.

The dividends that may be paid without prior regulatory approval are determined by formulas established by the applicable insurance regulations, as described above. The formulas that determine dividend capacity in the current year are dependent on, among other items, the prior year s ending statutory surplus and statutory net income. Dividend capacity for 2010 is based on statutory surplus and income at and for the year ended December 31, 2009. Without prior regulatory approval in 2010, Western Surety may pay dividends of $122.9 million to CNA Surety. CNA Surety received dividends of $0.5 million from its non-insurance subsidiary and no dividends from its insurance subsidiaries during the first nine months of 2010. CNA Surety received no dividends from its non-insurance subsidiary and $2.0 million from its insurance subsidiaries during the first nine months of 2009.

Combined statutory surplus totaled $763.3 million at September 30, 2010, resulting in a net written premium to statutory surplus ratio of 0.5 to 1. Insurance regulations restrict Western Surety s maximum net retention on a single surety bond to 10 percent of statutory surplus. Under the 2010 Excess of Loss Treaty, the Company s net retention on new bonds would generally be $15 million plus a 5% co-participation in the $90 million layer of excess reinsurance above the Company s retention. Based on statutory surplus as of September 30, 2010, this regulation would limit Western Surety s largest gross risk to $161.8 million. This surplus requirement may limit the amount of future dividends Western Surety could otherwise pay to CNA Surety.

In accordance with the provisions of intercompany tax sharing agreements between CNA Surety and its subsidiaries, the income tax of each subsidiary shall be determined based upon each subsidiary s separate return liability. Intercompany tax payments are made at such times when estimated tax payments would be required by the Internal Revenue Service. CNA Surety received tax sharing payments of $46.8 million and $29.3 million from its subsidiaries for the nine months ended September 30, 2010 and September 30, 2009, respectively.

Western Surety and Surety Bonding each qualify as an acceptable surety for federal and other public works project bonds pursuant to U.S. Department of Treasury regulations. U.S. Treasury underwriting limitations, the maximum net retention on a single federal surety bond, are based on an insurer s statutory surplus. Effective July 1, 2009 through June 30, 2010, the underwriting limitations of Western Surety and Surety Bonding were $54.7 million and $0.7 million, respectively. Effective July 1, 2010 through June 30, 2011, the underwriting limitations of Western Surety and Surety Bonding are $67.1 million and $0.8 million, respectively. Through the Quota Share Treaty previously discussed, CNA Surety has access to CCC and its affiliates U.S. Department of Treasury underwriting limitations. Effective July 1, 2010 through June 30, 2011, the underwriting limitations of CCC and its affiliates utilized under the Quota Share Treaty total $892.1 million. CNA Surety management believes that the foregoing U.S. Treasury underwriting limitations are sufficient for the conduct of its business.

CNA Surety management believes that the Company has sufficient available resources, including capital protection against large losses provided by the Company s excess of loss reinsurance arrangements, to meet its present capital needs.

Insurance Regulation and Supervision

CNA Surety s insurance subsidiaries are subject to periodic financial and market conduct examinations. These examinations are generally performed by the domiciliary state insurance regulatory authorities, however, they may be performed by any jurisdiction in which the insurer transacts business. During 2008, the South Dakota Division of Insurance began its financial examination of Western Surety, Surety Bonding and Universal Surety as of and for the period January 1, 2004 through December 31, 2008. The final financial examination report was filed with the South Dakota Division of Insurance on December 11, 2009. On January 13, 2010, the Company was notified that the final examination report was adopted by the Director of the South Dakota Division of Insurance as filed. No adverse findings were included in the final examination report.

Financial Condition

Investment Portfolio

The amortized cost, gross unrealized gains, gross unrealized losses, estimated fair value and unrealized OTTI losses of fixed income securities and the cost, gross unrealized gains, gross unrealized losses and estimated fair value of equity securities held by CNA Surety at September 30, 2010, by investment category, were as follows (dollars in thousands):

September 30, 2010	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses: Less Than 12 Months	Gross Unrealized Losses: More Than 12 Months	Estimated Fair Value	Unrealized OTTI Losses
Fixed income securities:						
U.S. Treasury securities and obligations of U.S. Government and agencies:						
U.S. Treasury	$ 17,287	$ 1,080	$	$	$ 18,367	$
U.S. Agencies	6,521	309			6,830	
Collateralized mortgage obligations residential	24,268	1,814			26,082	
Mortgage pass-through securities residential	75,569	3,426			78,995	
Obligations of states and political subdivisions	711,165	60,100		(786)	770,479	
Corporate bonds	458,489	34,253	(25)	(74)	492,643	
Collateralized mortgage obligations commercial	10,019	770			10,789	
Other asset-backed securities:						
Second mortgages/home equity loans residential	4,228			(242)	3,986	(1,021) [(a)]
Consumer credit receivables	9,997	282			10,279	
Other	9,686	742			10,428	

Total fixed income securities	1,327,229	102,776	(25)	(1,102)	1,428,878	$ (1,021)
Equity securities	1,736	211			1,947	
Total	$ 1,328,965	$ 102,987	$ (25)	$ (1,102)	$ 1,430,825	

(a) The unrealized loss position of this security was $0.2 million at September 30, 2010.

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The amortized cost, gross unrealized gains, gross unrealized losses, estimated fair value and unrealized OTTI losses of fixed income securities and the cost, gross unrealized gains, gross unrealized losses and estimated fair value of equity securities held by CNA Surety at December 31, 2009, by investment category, were as follows (dollars in thousands):

			Gross Unrealized Losses			
December 31, 2009	**Amortized Cost or Cost**	**Gross Unrealized Gains**	**Less Than 12 Months**	**More Than 12 Months**	**Estimated Fair Value**	**Unrealized OTTI Losses**
Fixed income securities:						
U.S. Treasury securities and obligations of U.S. Government and agencies:						
U.S. Treasury	$ 17,378	$ 970	$	$	$ 18,348	$
U.S. Agencies	9,794	337			10,131	
Collateralized mortgage obligations residential	30,709	1,383			32,092	
Mortgage pass-through securities residential	94,453	2,336	(232)		96,557	
Obligations of states and political subdivisions	696,505	35,847	(882)	(2,902)	728,568	
Corporate bonds	334,136	11,478	(1,248)	(257)	344,109	
Collateralized mortgage obligations commercial	10,024			(351)	9,673	
Other asset-backed securities:						
Second mortgages/home equity loans residential	5,501			(740)	4,761	(1,399) [(a)]
Consumer credit receivables	11,055	528			11,583	
Other	9,715	686			10,401	
Total fixed income securities	1,219,270	53,565	(2,362)	(4,250)	1,266,223	$ (1,399)
Equity securities	1,429	181			1,610	
Total	$ 1,220,699	$ 53,746	$ (2,362)	$ (4,250)	$ 1,267,833	

(a) The unrealized loss position of this security was $0.5 million at December 31, 2009.

The following table provides the composition of fixed income securities with an unrealized loss at September 30, 2010 in relation to the total of all fixed income securities by contractual maturities:

Contractual Maturity	**% of Estimated Fair Value**	**% of Unrealized Loss**
Due after one year through five years	29%	9%
Due after five years through ten years	49	65
Due after ten years	16	5
Asset-backed securities	6	21
Total	100%	100%

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The following table summarizes for fixed income securities in an unrealized loss position at September 30, 2010 and December 31, 2009, the aggregate fair value and gross unrealized loss by length of time those securities have been continuously in an unrealized loss position (dollars in thousands):

	September 30, 2010		December 31, 2009	
Unrealized Loss Aging	**Estimated Fair Value**	**Gross Unrealized Loss**	**Estimated Fair Value**	**Gross Unrealized Loss**
Fixed income securities:				
Investment grade [a]:				
0-6 months	$	$	$ 162,087	$ 2,362
13-24 months			11,176	469
Greater than 24 months	8,155	422	32,932	2,065
Total investment grade	8,155	422	206,195	4,896
Non-investment grade:				
0-6 months	6,235	25		
Greater than 24 months	17,700	680	17,346	1,716
Total non-investment grade	23,935	705	17,346	1,716
Total	$ 32,090	$ 1,127	$ 223,541	$ 6,612

(a) Investment grade is determined by using the Standard and Poor s (S&P) rating. If a security is not rated by S&P, the Moody s Investor Services (Moody s) rating is used. As of September 30, 2010 and December 31, 2009, all of the Company s fixed income securities were rated by S&P or Moody s.

Management believes the Company has the ability to hold all fixed income securities to maturity. However, the Company may dispose of securities prior to their scheduled maturity due to changes in interest rates, prepayments, tax and credit considerations, liquidity or regulatory capital requirements, or other similar factors. As a result, the Company considers all of its fixed income securities (bonds) and equity securities as available-for-sale, and as such, they are carried at fair value.

A security is in an unrealized loss position, or impaired, if the fair value of the security is less than its amortized cost adjusted for accretion, amortization and previously recorded OTTI losses. When a security is impaired, the impairment is evaluated to determine whether it is temporary or other-than-temporary.

A significant judgment in the valuation of investments is the determination of when an other-than-temporary decline in value has occurred. The Company follows a consistent and systematic process for identifying securities that sustain other-than-temporary declines in value. The Company has established a watch list that is reviewed by the Chief Financial Officer and one other executive officer on at least a quarterly basis. The watch list includes individual securities that fall below certain thresholds or that exhibit evidence of impairment indicators including, but not limited to, a significant adverse change in the financial condition and near-term prospects of the investment or a significant adverse change in legal factors, the business climate or credit ratings.

When a security is placed on the watch list, it is monitored for further market value changes and additional news related to the issuer s financial condition. The focus is on objective evidence that may influence the evaluation of impairment factors. The decision to record an other-than-temporary impairment loss incorporates both quantitative criteria and qualitative information.

In determining whether an equity security is other-than-temporarily impaired, the Company considers a number of factors including, but not limited to: (a) the length of time and the extent to which the market value has been less than book value, (b) the financial condition and near-term prospects of the issuer, (c) the intent and ability of the Company to retain its investment for a period of time sufficient to allow for any anticipated recovery in value and (d) general market conditions and industry or sector specific factors. Currently, the Company s equity portfolio is comprised solely of mutual funds related to the Company s deferred compensation plan, which is an unfunded, nonqualified deferred compensation plan for a select group of management or highly compensated employees. Due to the nature of the plan, the Company does not assert the ability to hold these securities until their recovery in value. As such, if any of these securities are in an unrealized loss position, they are considered to be other-than-temporarily impaired.

For equity securities for which an other-than-temporary impairment loss has been identified, the security is written down to fair value and the resulting losses are recognized in realized gains/losses in the Condensed Consolidated Statements of Income.

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Fixed income securities in an unrealized loss position that the Company intends to sell, or it more likely than not will be required to sell before recovery of amortized cost, are considered to be other-than-temporarily impaired. These securities are written down to fair value and the resulting losses are recognized in realized gains/losses in the Condensed Consolidated Statements of Income.

The remaining fixed income securities in an unrealized loss position are evaluated to determine if a credit loss exists. To determine if a credit loss exists, the Company considers a number of factors including, but not limited to: (a) the financial condition and near-term prospects of the issuer, (b) credit ratings of the securities, (c) whether the debtor is current on interest and principal payments (d) the length of time and the extent to which the market value has been less than book value and (e) general market conditions and industry or sector specific factors.

In addition to these factors, the Company considers the results of discounted cash flow modeling using assumptions representative of current market conditions as well as those specific to the Company s particular security holdings. For asset-backed and mortgage-backed securities, the focus of this analysis is on assessing the sufficiency and quality of underlying collateral and timing of cash flows. If the discounted expected cash flows for a security equal or exceed the amortized cost of that security, no credit loss exists and the security is deemed to be temporarily impaired.

Fixed income securities in an unrealized loss position for which management believes a credit loss exists are considered to be other-than-temporarily impaired. For these fixed income securities, the Company bifurcates OTTI losses into a credit component and a non-credit component. The credit component, which represents the difference between the discounted expected cash flows and the fixed income security s amortized cost, is recognized in earnings. The non-credit component is recognized in other comprehensive income and represents the difference between fair value and the discounted cash flows that the Company expects to collect.

At September 30, 2010, the Company holds 320 fixed income securities in an unrealized gain position with a total estimated fair value of $1,396.8 million and an aggregate gross unrealized gain of $102.8 million.

The following table summarizes securities in a gross unrealized loss position by investment category and by credit rating. The table also discloses the corresponding count of securities in an unrealized loss position and estimated fair value by category (in thousands of dollars):

	Gross Unrealized Losses				
September 30, 2010	**A**	**BBB**	**Total**	**Count**	**Estimated Fair Value**
Fixed income securities:					
Investment grade[(a)]:					
Obligations of states and political subdivisions	$ 348	$	$ 348	1	$ 5,215
Corporate bonds		74	74	1	2,940
Total investment grade	348	74	422	2	8,155
Non-investment grade:					
Obligations of states and political subdivisions			438	2	15,716
Corporate bonds			25	4	6,235
Other asset-backed securities:					
Second mortgages/home equity loans residential			242	1	1,984
Total non-investment grade			705	7	23,935
Total	$ 348	$ 74	$ 1,127	9	$ 32,090

(a) Securities are categorized using the S&P rating. If a security is not rated by S&P, the Moody s rating is used. At September 30, 2010, all of the Company s fixed income securities were rated by S&P or Moody s.

As a result of improving market conditions, only two of the Company s investment grade fixed income securities were in an unrealized loss position at September 30, 2010. One security, issued by a governmental utility authority, had an unrealized loss of $0.3 million, or 6.3% of the security s amortized cost. The other security, issued by a large student loan provider, had an unrealized loss of $0.1 million, or 2.5% of the security s amortized cost. The unrealized loss on each of these securities has improved compared to December 31, 2009 when the unrealized losses were $0.6 million, or 11.3% of amortized cost, and $0.3 million, or 8.5% of amortized cost, respectively. The Company has no current intent to sell these securities, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost. The Company does not believe the unrealized losses on these securities are indicative of credit losses and, as such, has not recorded an OTTI loss on these securities at September 30, 2010.

Seven of the Company s non-investment grade fixed income securities were in an unrealized loss position at September 30, 2010. Two of these securities in an unrealized loss position are obligations of states and political subdivisions. Both of these securities were issued by governmental utility authorities. At September 30, 2010, one of these securities had an unrealized loss of $0.1 million, or 1.0% of its amortized cost, and the other had an unrealized loss of $0.4 million, or 3.5% of its amortized cost. The unrealized loss position of these securities was $1.2 million in total at December 31, 2009. Based on the underlying fundamentals of these securities, the Company continues to believe that all interest and principal will be paid according to their contractual terms. The Company has no current intent to sell these securities, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost. As such, the Company has not recorded an OTTI loss on these securities at September 30, 2010.

During the third quarter of 2010, the Company began a program to invest a modest amount in non-investment grade corporate bonds due to the relative attractiveness of the sector. Four securities purchased under this program were in an unrealized loss position at September 30, 2010. In the aggregate, these four securities had an unrealized loss of less than $0.1 million as of September 30, 2010. Each of the individual securities was in an unrealized loss position representing less than 1.0% of that security s amortized cost. The Company has no current intent to sell these securities, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost. The Company does not believe the unrealized losses on these securities are indicative of credit losses and, as such, has not recorded an OTTI loss on these securities at September 30, 2010.

At September 30, 2010 the Company s exposure to sub-prime home loans is limited to two asset-backed securities collateralized by sub-prime home loans which originated prior to 2005. The estimated fair value of these securities was $4.0 million at September 30, 2010. One of these securities was in an unrealized loss position and rated below investment grade at September 30, 2010. During the nine months ended September 30, 2010, the Company received repayments on this security of $0.5 million, or approximately 18% of the par value outstanding at December 31, 2009. As discussed previously, this security was determined to have credit losses totaling $0.1 million during the nine months ended September 30, 2010. The non-credit component of this security s OTTI recognized in accumulated other comprehensive income at September 30, 2010 was $0.2 million. The Company believes the non-credit component of the unrealized loss on this security is primarily attributable to this asset class being out of favor with investors and is not indicative of the quality of the underlying collateral. The Company has no current intent to sell this security, nor is it more likely than not that it will be required to sell prior to recovery of the adjusted amortized cost.

As of September 30, 2010, $417.6 million of the Company s investments were guaranteed by one of three major mono-line bond insurers. This includes $415.6 million of bonds of states and political obligations, or about 54% of the Company s investments in this type of security. Investments in obligations of states and political subdivisions represent approximately 54% of the Company s invested assets. The ratings on these securities reflect the higher of the underlying rating of the issuer or the insurer s rating. Of the $417.6 million of bonds that were insured, $92.7 million of these securities reflect credit rating enhancement due to the guarantee. The underlying ratings of the enhanced securities are $66.8 million AA, $25.3 million A and $0.6 million BBB. The underlying ratings of all municipal holdings remain very strong and carry an average rating of AA. The Company views bond insurance as credit enhancement and not credit substitution and a credit review is performed on each issuer of bonds purchased. Based on the strong underlying credit quality of its insured bonds of states and political subdivisions, the Company believes that any impact of potential ratings downgrades or other difficulties of the mono-line bond insurers would not have a significant impact on the Company s financial position or results of operations.

The Company has no current intent to sell any of the securities in an unrealized loss position, nor is it more likely than not that it will be required to sell these securities prior to recovery of amortized cost. The Company believes that all of the securities in an unrealized loss position will recover in value and that none of these unrealized losses were due to factors regarding credit-worthiness. Based on the current facts and circumstances of the Company s particular security holdings, the Company has determined that no additional OTTI losses related to the securities in an unrealized loss position are required to be recorded.

Invested assets are exposed to various risks, such as interest rate, market and credit risks. Due to the level of risk associated with certain of these invested assets and the level of uncertainty related to changes in the value of these assets, it is possible that changes in risks in the near term may significantly affect the amounts reported in the Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Income.

Impact of Pending Accounting Standards

In October 2010, the Financial Accounting Standards Board issued Accounting Standards Update No. 2010-26, Financial Services Insurance (Topic 944) Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts. This updated accounting guidance modifies the definition of the types of costs incurred to acquire or renew insurance contracts that may be capitalized. Under the new guidance, these costs include those costs that are incremental direct costs and certain costs that are directly related to successful contract acquisitions. This accounting guidance is effective for fiscal years, and interim periods within those

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fiscal years, beginning after December 15, 2011 with prospective or retrospective application allowed. The Company is currently assessing the available application methods as well as the impact this accounting guidance will have on its financial condition and results of operations.

FORWARD-LOOKING STATEMENTS

This report includes a number of statements, which relate to anticipated future events (forward-looking statements) rather than actual present conditions or historical events. Forward-looking statements generally include words such as believes, expects, intends, anticipates, estimates and similar expressions. Forward-looking statements in this rep include expected developments in the Company s insurance business, including losses and loss reserves; the impact of routine ongoing insurance reserve reviews being conducted by the Company; the routine state regulatory examinations of the Company s primary insurance company subsidiaries, and the Company s responses to the results of those reviews and examinations; the Company s expectations concerning its revenues, earnings, expenses and investment activities; expected cost savings and other results from the Company s expense reduction and restructuring activities; and the Company s proposed actions in response to trends in its business.

Forward-looking statements, by their nature, are subject to a variety of inherent risks and uncertainties that could cause actual results to differ materially from the results projected. Many of these risks and uncertainties cannot be controlled by the Company.

Some examples of these risks and uncertainties are:

general economic and business conditions;

changes in financial markets such as fluctuations in interest rates, long-term periods of low interest rates, credit conditions and currency, commodity and stock prices;

the ability of the Company s contract principals to fulfill their bonded obligations;

the effects of corporate bankruptcies on surety bond claims, as well as on capital markets;

changes in foreign or domestic political, social and economic conditions;

regulatory initiatives and compliance with governmental regulations, judicial decisions, including interpretation of policy provisions, decisions regarding coverage, trends in litigation and the outcome of any litigation involving the Company, and rulings and changes in tax laws and regulations;

regulatory limitations, impositions and restrictions upon the Company, including the effects of assessments and other surcharges for guaranty funds and other mandatory pooling arrangements;

the impact of competitive products, policies and pricing and the competitive environment in which the Company operates, including changes in the Company s books of business;

product and policy availability and demand and market responses, including the level of ability to obtain rate increases and decline or non-renew underpriced accounts, to achieve premium targets and profitability and to realize growth and retention estimates;

development of claims and the impact on loss reserves, including changes in claim settlement practices;

the performance of reinsurance companies under reinsurance contracts with the Company;

results of financing efforts, including the Company s ability to access capital markets;

changes in the Company s composition of operating segments;

the sufficiency of the Company s loss reserves and the possibility of future increases in reserves;

the risks and uncertainties associated with the Company s loss reserves; and, the possibility of changes in the Company s ratings by ratings agencies, including the inability to access certain markets or distribution channels and the required collateralization of future payment obligations as a result of such changes, and changes in rating agency policies and practices.

Any forward-looking statements made in this report are made by the Company as of the date of this report. The Company does not have any obligation to update or revise any forward-looking statement contained in this report, even if the Company s expectations or any related events, conditions or circumstances change.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

CNA Surety s investment portfolio is subject to economic losses due to adverse changes in the fair value of its financial instruments, or market risk. Interest rate risk represents the largest market risk factor affecting the Company s consolidated financial condition due to its significant level of investments in fixed income securities. Increases and decreases in prevailing interest rates generally translate into decreases and increases in the fair value of the Company s fixed income portfolio. The fair value of these interest rate sensitive instruments may also be affected by the credit-worthiness of the issuer, prepayment options, relative value of alternative investments, the liquidity of the instrument, income tax considerations and general market conditions. The Company manages its exposure to interest rate risk primarily through an asset/liability matching strategy. The Company s exposure to interest rate risk is mitigated by the relative short-term nature of its insurance and other liabilities. The targeted effective duration of the Company s investment portfolio is approximately 5 years, consistent with the expected duration of its insurance and other liabilities.

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The tables below summarize the estimated effects of certain hypothetical changes in interest rates. It is assumed that the changes occur immediately and uniformly across each investment category. At September 30, 2010 and December 31, 2009, the selected hypothetical changes in market interest rates reflect the Company s expectations of the reasonably possible scenarios over a one-year period and the hypothetical fair values are based upon the same prepayment assumptions that were utilized in computing fair values. Significant variations in market interest rates could produce changes in the timing of repayments due to prepayment options available. The fair value of such instruments could be affected and therefore actual results might differ from those reflected in the following tables.

	Fair Value at September 30, 2010	Hypothetical Change in Interest Rate (bp=basis points)	Estimated Fair Value After Hypothetical Change in Interest Rate	Hypothetical Percentage Decrease in Stockholders Equity
		(Dollars in thousands)		
U.S. Government and government agencies and authorities	$ 130,274			
		200 bp increase	$ 123,338	(0.4)%
		150 bp increase	125,628	(0.3)
		100 bp increase	127,720	(0.2)
		50 bp increase	129,545	
States, municipalities and political subdivisions	770,479			
		200 bp increase	690,318	(5.0)
		150 bp increase	711,369	(3.7)
		100 bp increase	733,201	(2.3)
		50 bp increase	755,838	(0.9)
Corporate bonds	492,643			
		200 bp increase	453,757	(2.4)
		150 bp increase	464,203	(1.8)
		100 bp increase	474,992	(1.1)
		50 bp increase	486,134	(0.4)

Mortgage-backed and asset-backed	35,482			
		200 bp increase	34,086	(0.1)
		150 bp increase	34,473	(0.1)
		100 bp increase	34,869	
		50 bp increase	35,273	
Total fixed income securities available-for-sale	$ 1,428,878			
		200 bp increase	1,301,499	(8.0)
		150 bp increase	1,335,673	(5.8)
		100 bp increase	1,370,782	(3.6)
		50 bp increase	1,406,790	(1.4)

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	Fair Value at December 31, 2009	Hypothetical Change in Interest Rate (bp=basis points)	Estimated Fair Value After Hypothetical Change in Interest Rate	Hypothetical Percentage Decrease in Stockholders Equity
		(Dollars in thousands)		
U.S. Government and government agencies and authorities	$ 157,128			
		200 bp increase	$ 144,937	(0.9)%
		150 bp increase	148,310	(0.6)
		100 bp increase	151,570	(0.4)
		50 bp increase	154,580	(0.2)
States, municipalities and political subdivisions	728,568			
		200 bp increase	641,122	(6.2)
		150 bp increase	661,735	(4.7)
		100 bp increase	683,176	(3.2)
		50 bp increase	705,453	(1.6)
Corporate bonds	344,109			
		200 bp increase	310,703	(2.4)
		150 bp increase	318,610	(1.8)
		100 bp increase	326,806	(1.2)
		50 bp increase	335,301	(0.6)
Mortgage-backed and asset-backed	36,418			
		200 bp increase	34,525	(0.1)
		150 bp increase	34,982	(0.1)

		100 bp increase	35,450	(0.1)
		50 bp increase	35,928	
Total fixed income securities available-for-sale	$ 1,266,223			
		200 bp increase	1,131,287	(9.6)
		150 bp increase	1,163,637	(7.2)
		100 bp increase	1,197,002	(4.9)
		50 bp increase	1,231,262	(2.4)

ITEM 4. CONTROLS AND PROCEDURES

The Company maintains a system of disclosure controls and procedures which are designed to ensure that information required to be disclosed by the Company in reports that it files or submits to the Securities and Exchange Commission under the Securities Exchange Act of 1934 (the Exchange Act), including this report, is recorded, processed, summarized and reported on a timely basis. These disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed under the Exchange Act is accumulated and communicated to the Company s management on a timely basis to allow decisions regarding required disclosure.

The Company s principal executive officer and its principal financial officer undertook an evaluation of the Company s disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report and concluded that the Company s controls and procedures were effective.

There were no changes in the Company s internal control over financial reporting that occurred during the Company s last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS Information on the Company s legal proceedings is set forth in Note 8 of the Condensed Consolidated Financial Statements included under Part 1, Item 1.

ITEM 1A. RISK FACTORS Information on the Company s risk factors is set forth in Item 1A Risk Factors in the Company s Annual Report on Form 10-K for the year-ended December 31, 2009.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS **None**.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES **None.**

ITEM 4. **None.**

ITEM 5. OTHER INFORMATION **Reports on Form 8-K:**

July 30, 2010; CNA Surety Corporation Earnings Press Release issued on July 30, 2010.

August 6, 2010; CNA Surety Corporation Change in Directors or Principal Officers issued on August 6, 2010.

ITEM 6. EXHIBITS

	Exhibit Number
Certification pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Chief Executive Officer.	31(1)
Certification pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Chief Financial Officer.	31(2)
Written Statement of the Chief Executive Officer of CNA Surety Corporation pursuant to 18 U.S.C. 1350 (as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002).	32(1)*
Written Statement of the Chief Financial Officer of CNA Surety Corporation pursuant to 18 U.S.C. 1350 (as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002).	32(2)*

* Exhibits 32(1) and 32(2) are being furnished and shall not be deemed filed for the purpose of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liabilities of that Section. These Exhibits shall not be incorporated by reference into any registration statement or other document pursuant to the Securities Act of 1933, as

amended.

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SIGNATURES

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

CNA SURETY CORPORATION (Registrant)

/s/ John F. Welch
John F. Welch
President and Chief Executive Officer

/s/ John F. Corcoran
John F. Corcoran
Senior Vice President and Chief Financial Officer

Date: October 29, 2010

EXHIBIT INDEX

31(1)	Certification pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Chief Executive Officer.
31(2)	Certification pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Chief Financial Officer.
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