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CNA SURETY CORP
Form 10-Q
October 31, 2005

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

☒ [X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934

For the quarterly period ended September 30, 2005

OR

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

Commission file number: 1-13277

CNA SURETY CORPORATION
(Exact name of Registrant as specified in its Charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

36-4144905
(I.R.S. Employer Identification No.)

CNA CENTER, CHICAGO, ILLINOIS
(Address of principal executive offices)

60685
(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 ☒ [X] No ☐ []

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes ☒ [X] 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:

43,260,693 shares of Common Stock, \$.01 par value as of 10/24/2005.

CNA SURETY CORPORATION AND SUBSIDIARIES

INDEX

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	PAGE

PART I. FINANCIAL INFORMATION:	
Item 1. Condensed Consolidated Financial Statements (Unaudited):	
Report of Independent Registered Public Accounting Firm.....	3
Condensed Consolidated Balance Sheets at September 30, 2005 and at December 31, 2004.....	4
Condensed Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2005 and 2004.....	5
Condensed Consolidated Statements of Stockholders' Equity for the Three and Nine Months Ended September 30, 2005 and 2004.....	6
Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2005 and 2004.....	7
Notes to Condensed Consolidated Financial Statements.....	8
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.....	17
Item 3. Quantitative and Qualitative Disclosures About Market Risk....	32
Item 4. Controls and Procedures.....	33
PART II. OTHER INFORMATION:	
Item 1. Legal Proceedings.....	33
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds...	33
Item 3. Defaults Upon Senior Securities.....	33
Item 4. Submission of Matters to a Vote of Security Holders.....	33
Item 5. Other Information.....	33
Item 6. Exhibits.....	34

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
CNA Surety Corporation
Chicago, Illinois

We have reviewed the accompanying condensed consolidated balance sheet of CNA Surety Corporation and subsidiaries as of September 30, 2005, and the related condensed consolidated statements of income and stockholders' equity for the three-month and nine-month periods ended September 30, 2005 and 2004 and the related condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2005 and 2004. These interim financial statements are the responsibility of the Corporation's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of CNA Surety Corporation and subsidiaries as of December 31, 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated February 25, 2005, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2004 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Deloitte & Touche LLP
Chicago, Illinois
October 31, 2005

3

CNA SURETY CORPORATION AND SUBSIDIARIES CONDENSED CONSOLIDATED BALANCE SHEETS (AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA) (UNAUDITED)

	SEPTEMBER 2005

ASSETS	
Invested assets and cash:	
Fixed income securities, at fair value (amortized cost: \$696,150 and \$698,374)...	\$ 711,89
Equity securities, at fair value (cost: \$1,144 and \$1,084).....	1,24
Short-term investments, at cost (approximates fair value).....	91,62
Other investments, at fair value (cost: \$1,020 and \$1,058).....	1,02

Total invested assets.....	805,79
Cash.....	7,79
Deferred policy acquisition costs.....	106,74
Insurance receivables:	
Premiums, including \$13,041 and \$11,012 from affiliates (net of allowance for doubtful accounts: \$1,752 and \$2,153).....	44,22
Reinsurance, including \$3,105 and \$5,364 from affiliates.....	74,69
Deposit with affiliated ceding company.....	32,33
Intangible assets (net of accumulated amortization: \$25,523 and \$25,523).....	138,78
Current income taxes receivable.....	1,39
Property and equipment, at cost (less accumulated depreciation and amortization: \$23,878 and \$21,600).....	17,62
Prepaid reinsurance premiums.....	8,40
Accrued investment income.....	8,77
Other assets.....	3,49

Total assets.....	\$1,250,05
	=====
LIABILITIES	

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Reserves:

Unpaid losses and loss adjustment expenses.....	\$ 405,94
Unearned premiums.....	252,12

Total reserves.....	658,06
Debt.....	60,56
Deferred income taxes, net.....	21,15
Current income taxes payable.....	
Reinsurance and other payables to affiliates.....	8,99
Accrued expenses.....	13,78
Other liabilities.....	25,79

Total liabilities.....	\$ 788,36

Commitments and contingencies (See Notes 4, 5, 6, & 7)	
STOCKHOLDERS' EQUITY	
Common stock, par value \$.01 per share, 100,000 shares authorized; 44,659 shares issued and 43,259 shares outstanding at September 30, 2005 and 44,423 shares issued and 43,015 shares outstanding at December 31, 2004.....	44
Additional paid-in capital.....	258,54
Retained earnings.....	207,41
Accumulated other comprehensive income.....	10,30
Treasury stock, at cost.....	(15,02)

Total stockholders' equity.....	461,68

Total liabilities and stockholders' equity.....	\$1,250,05
	=====

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

4

CNA SURETY CORPORATION AND SUBSIDIARIES CONDENSED CONSOLIDATED STATEMENTS OF INCOME (AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA) (UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30		NINE MONTHS ENDED SEPTEMBER 30
	2005	2004	2005
	-----	-----	-----
Revenues:			
Net earned premium.....	\$91,061	\$83,068	\$256,881
Net investment income.....	8,681	7,688	24,706
Net realized investment gains.....	108	194	2,124
	-----	-----	-----
Total revenues.....	99,850	90,950	283,711
	-----	-----	-----
Expenses:			
Net losses and loss adjustment expenses.....	19,976	22,847	104,330
Net commissions, brokerage and other underwriting expenses...	51,891	52,245	150,593
Interest expense.....	938	664	2,552

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Total expenses.....	72,805	75,756	257,475
Income before income taxes.....	27,045	15,194	26,236
Income tax expense.....	7,262	4,220	4,313
Net income.....	\$19,783	\$10,974	\$ 21,923
Earnings per common share.....	\$ 0.46	\$ 0.26	\$ 0.51
Earnings per common share, assuming dilution.....	\$ 0.46	\$ 0.25	\$ 0.51
Weighted average shares outstanding.....	43,168	43,001	43,174
Weighted average shares outstanding, assuming dilution.....	43,385	43,048	43,394

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

5

CNA SURETY CORPORATION AND SUBSIDIARIES CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (AMOUNTS IN THOUSANDS) (UNAUDITED)

	COMMON STOCK SHARES OUTSTANDING	COMMON STOCK	ADDITIONAL PAID-IN CAPITAL	COMPREHENSIVE INCOME (LOSS)
Balance, December 31, 2003.....	42,980	\$444	\$255,816	
Comprehensive income:				
Net income.....	--	--	--	\$27,500
Other comprehensive income:				
Change in unrealized gains on securities, after income tax benefit of \$1,621 (net of reclassification adjustment of \$1,662, after income tax expense of \$895).....	--	--	--	(3,000)
Total comprehensive income.....				\$24,500
Issuance of treasury stock to employee stock purchase program.....	13	--	(34)	
Stock options exercised and other.....	8	--	67	
Balance, September 30, 2004.....	43,001	\$444	\$255,849	
Balance, December 31, 2004.....	43,015	\$444	\$255,996	
Comprehensive income:				
Net income.....	--	--	--	\$21,900
Other comprehensive income:				
Change in unrealized gains on securities, after income tax benefit of \$4,978 (net of				

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reclassification adjustment of \$1,113, after income tax expense of \$599).....	--	--	--	(9,2
Total comprehensive income.....				\$12,6
Issuance of treasury stock to employee stock purchase program.....	8	--	(5)	
Stock options exercised and other.....	236	3	2,554	
Balance, September 30, 2005.....	43,259	\$447	\$258,545	

	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE INCOME	TREASURY STOCK AT COST	TO STOCKH EQ
Balance, December 31, 2003.....	\$145,786	\$23,351	\$ (15,256)	\$41
Comprehensive income:				
Net income.....	27,533	--	--	2
Other comprehensive income:				
Change in unrealized gains on securities, after income tax benefit of \$1,621 (net of reclassification adjustment of \$1,662, after income tax expense of \$895).....	--	(3,012)	--	(
Issuance of treasury stock to employee stock purchase program.....	--	--	140	
Stock options exercised and other.....	--	--	--	
Balance, September 30, 2004.....	\$173,319	\$20,339	\$ (15,116)	\$43
Balance, December 31, 2004.....	\$185,496	\$19,551	\$ (15,116)	\$44
Comprehensive income:				
Net income.....	21,923	--	--	2
Other comprehensive income:				
Change in unrealized gains on securities, after income tax benefit of \$4,978 (net of reclassification adjustment of \$1,113, after income tax expense of \$599).....	--	(9,246)	--	(
Issuance of treasury stock to employee stock purchase program.....	--	--	87	
Stock options exercised and other.....	--	--	--	
Balance, September 30, 2005.....	\$207,419	\$10,305	\$ (15,029)	\$46

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

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(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30,	
	2005	2004
OPERATING ACTIVITIES:		
Net income	\$ 21,923	\$ 27,533
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,372	3,416
Accretion of bond discount, net	2,068	2,170
Net realized investment gains	(2,124)	(2,476)
Changes in:		
Insurance receivables	12,296	70,632
Reserve for unearned premiums	26,101	12,866
Reserve for unpaid losses and loss adjustment expenses	42,560	(36,138)
Deposit with affiliated ceding company	(32,332)	--
Deferred policy acquisition costs	(4,614)	(1,718)
Deferred income taxes, net	(886)	(1,667)
Reinsurance and other payables to affiliates	8,533	(50)
Prepaid reinsurance premiums	(449)	(4,201)
Accrued expenses	(3,306)	29,302
Other assets and liabilities	(4,959)	3,847
Net cash provided by operating activities	68,183	103,516
INVESTING ACTIVITIES:		
Fixed income securities:		
Purchases	(119,603)	(154,014)
Maturities	30,071	18,156
Sales	90,979	41,962
Purchases of equity securities	(694)	(680)
Proceeds from the sale of equity securities	709	706
Changes in short-term investments	(62,985)	(21,050)
Purchases of property and equipment, net	(5,233)	(2,010)
Changes in receivables/payables for securities sold/purchased	(6)	142
Other, net	1,522	(1,287)
Net cash used in investing activities	(65,240)	(118,075)
FINANCING ACTIVITIES:		
Proceeds from long-term debt	--	30,930
Principal payments on debt	(5,000)	(15,417)
Debt issuance costs	(125)	(506)
Employee stock option exercises and other	2,552	32
Issuance of treasury stock to employee stock purchase plan	87	140
Net cash (used in) provided by financing activities	(2,486)	15,179
Increase in cash	457	620
Cash at beginning of period	7,336	7,965
Cash at end of period	\$ 7,793	\$ 8,585

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Supplemental Disclosure of Cash Flow Information:

Cash paid during the period for:

Interest	\$ 2,180	\$ 1,366
Income taxes	10,077	\$ (17,968)

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

7

CNA SURETY CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2005 (UNAUDITED)

1. SIGNIFICANT ACCOUNTING POLICIES

FORMATION OF CNA SURETY CORPORATION AND MERGER

In December 1996, CNA Financial Corporation ("CNAF") and 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 ("USA"), into CNA Surety. CNAF, through its operating subsidiaries, writes multiple lines of property and casualty insurance, including surety business that is reinsured by Western Surety. CNAF owns approximately 63% of the outstanding common stock of CNA Surety. Loews Corporation ("Loews") owns approximately 91% of the outstanding common stock of CNAF. 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"). CIC was acquired by CNAF on May 10, 1995. The combined surety operations of CCC and CIC are referred to herein as CCC Surety Operations.

PRINCIPLES OF CONSOLIDATION

The 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 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 2004 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

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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. Certain reclassifications have been made to the 2004 financial statements to conform with the presentation in the 2005 Condensed Consolidated Financial Statements.

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.

8

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,	
	2005	2004	2005	2004
Net income	\$19,783	\$10,974	\$21,923	\$27,533
Shares:				
Weighted average shares outstanding	43,140	42,995	43,015	42,980
Weighted average shares of options exercised and additional stock issuance	28	6	159	15
Total weighted average shares outstanding	43,168	43,001	43,174	42,995
Effect of dilutive options	217	47	220	53
Total weighted average shares outstanding, assuming dilution	43,385	43,048	43,394	43,048
Earnings per share	\$ 0.46	\$ 0.26	\$ 0.51	\$ 0.64
Earnings per share, assuming dilution	\$ 0.46	\$ 0.25	\$ 0.51	\$ 0.64

No adjustments were made to reported net income in the computation of earnings per share. Options to purchase shares of common stock of 0.4 million for the three and nine months ended September 30, 2005 and 0.9 million for the three and nine months ended September 30, 2004 were excluded from the calculation of diluted earnings per share because the exercise price of these options was greater than the average market price of CNA Surety's common stock.

The Company applies the intrinsic value method per Accounting Principles Board ("APB") Opinion No. 25 "Accounting for Stock Issued to Employees" ("APB Opinion No. 25"), and related interpretations, in accounting for its plans as allowed for under the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123").

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Accordingly, no compensation expense has been recognized for its stock-based incentive plans as the exercise price of the granted options equals the market price at the grant date. The following table illustrates the effect on net income and earnings per share data if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock based compensation under the Company's stock-based compensation plan (amounts in thousands, except for per share data):

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2005	2004	2005	2004
Net income	\$19,783	\$10,974	\$21,923	\$27,533
Less: Total stock based compensation cost determined under the fair value method, net of tax	(94)	(159)	(491)	(390)
Pro forma net income	\$19,689	\$10,815	\$21,432	\$27,143
Basic and diluted earnings per share, as reported ..	\$ 0.46	\$ 0.26	\$ 0.51	\$ 0.64
Basic earnings per share, pro forma	\$ 0.46	\$ 0.25	\$ 0.50	\$ 0.63
Diluted earnings per share, pro forma	\$ 0.45	\$ 0.25	\$ 0.49	\$ 0.63

ACCOUNTING PRONOUNCEMENTS

In December of 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (revised 2004), "Share-Based Payment ("SFAS 123R"), that amends SFAS No. 123, as originally issued in May of 1995. SFAS 123R addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. SFAS 123R supercedes APB Opinion No. 25. After the effective date of this standard, entities will not be permitted to use the intrinsic value method specified in APB 25 to measure compensation expense and generally would be required to measure compensation expense using a fair-value based method. Public companies are to apply this standard using either the modified prospective method or the modified retrospective method. The modified prospective method requires a company to (a) record compensation expense for all awards it grants after the date it adopts the standard and (b) record compensation expense for the unvested portion of previously granted awards that remain outstanding at the date of adoption. The modified retrospective method requires companies to record compensation expense to either (a) all prior years for which SFAS 123 was effective (i.e. for all fiscal years beginning after December 15, 2004) or (b) only to prior interim periods in the year of initial adoption if the effective date of SFAS 123R does not coincide with the beginning of the fiscal year. SFAS 123R is effective for annual periods beginning after June 15, 2005. The SEC issued Staff Accounting Bulletin ("SAB") No. 107 that provides implementation guidance on the adoption of SFAS 123R. Adoption of this standard is not expected to have a material impact on the Company's results of operations and/or equity.

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2. INVESTMENTS

The estimated fair value and amortized cost or cost of fixed income and equity securities held by CNA Surety at September 30, 2005 and December 31, 2004, by investment category, were as follows (dollars in thousands):

			GROSS UNREALIZED LOSS	
	AMORTIZED	GROSS	LESS THAN 12	MORE THAN 12
SEPTEMBER 30, 2005	COST OR	UNREALIZED	MONTHS	MONTHS
-----	COST	GAINS	-----	-----
Fixed income securities:				
U.S. Treasury securities and obligations of U.S.				
Government and agencies:				
U.S. Treasury.....	\$ 15,650	\$ 38	\$ (131)	\$ (131)
U.S. Agencies.....	14,120	26	(125)	(125)
Collateralized mortgage obligations.....	18,661	449	(99)	(99)
Mortgage pass-through securities.....	48,736	110	(430)	(430)
Obligations of states and political subdivisions...	465,506	16,461	(1,176)	(1,176)
Corporate bonds.....	75,602	2,244	(656)	(656)
Non-agency collateralized mortgage obligations.....	22,203	--	(459)	(459)
Other asset-backed securities:				
Second mortgages/home equity loans.....	25,924	133	(122)	(122)
Other.....	6,748	167	(70)	(70)
Redeemable preferred stock.....	3,000	188	--	--
	-----	-----	-----	-----
Total fixed income securities.....	696,150	19,816	(3,268)	(3,268)
Equity securities.....	1,144	105	--	--
	-----	-----	-----	-----
Total.....	\$697,294	\$19,921	\$ (3,268)	\$ (3,268)
	=====	=====	=====	=====

			GROSS UNREALIZED LOSS	
	AMORTIZED	GROSS	LESS THAN 12	MORE THAN 12
DECEMBER 31, 2004	COST OR	UNREALIZED	MONTHS	MONTHS
-----	COST	GAINS	-----	-----
Fixed income securities:				
U.S. Treasury securities and obligations of U.S.				
Government and agencies:				
U.S. Treasury.....	\$ 55,818	\$ 255	\$ (39)	\$ (39)
U.S. Agencies.....	4,576	39	(9)	(9)
Collateralized mortgage obligations.....	18,260	590	(105)	(105)
Mortgage pass-through securities.....	56,696	325	(249)	(249)
Obligations of states and political subdivisions...	431,624	23,467	(387)	(387)
Corporate bonds.....	94,363	4,735	(27)	(27)
Non-agency collateralized mortgage obligations.....	2,078	3	--	--
Other asset-backed securities:				
Second mortgages/home equity loans.....	20,942	241	(69)	(69)
Credit card receivables.....	867	--	--	--
Other.....	7,794	391	--	--
Redeemable preferred stock.....	5,356	941	--	--
	-----	-----	-----	-----

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Total fixed income securities.....	698,374	30,987	(885)	(1
Equity securities.....	1,084	114	--	---
	-----	-----	-----	---
Total.....	\$699,458	\$31,101	\$(885)	\$(1
	=====	=====	=====	=====

The Company's investment portfolio generally is 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.

10

CNA Surety classifies its fixed income securities and its equity securities as available-for-sale, and as such, they are carried at fair value. The amortized cost of fixed income securities is adjusted for amortization of premiums and accretion of discounts to maturity, which is included in net investment income. Changes in fair value are reported as a component of other comprehensive income, exclusive of other-than-temporary impairment losses, if any.

As of September 30, 2005, 70 separate securities held by the Company were in an unrealized loss position. Of these, 46 securities were rated "AAA" by Standard and Poor's ("S&P") and "Aaa" by Moody's Investor Services ("Moody's"). One security was rated below investment grade by Moody's and investment grade by S&P. Only two securities were in loss positions that exceeded 5% of their respective book values, with the largest unrealized loss being approximately 6% of that security's book value. The Company believes that virtually all of the unrealized losses have resulted from changes in interest rates. No other-than-temporary impairments were recorded for the nine months ended September 30, 2005. No other-than-temporary impairments were recorded for the year ended December 31, 2004.

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.

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,	
-----	-----
2005	2004
-----	-----

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	WRITTEN	EARNED	WRITTEN	EARNED
	-----	-----	-----	-----
Direct	\$ 83,428	\$ 76,128	\$ 71,225	\$ 64,802
Assumed	30,054	28,490	30,926	35,127
Ceded	(10,451)	(13,557)	(15,734)	(16,861)
	-----	-----	-----	-----
	\$103,031	\$ 91,061	\$ 86,417	\$ 83,068
	=====	=====	=====	=====

	NINE MONTHS ENDED SEPTEMBER 30,			
	2005		2004	
	-----	-----	-----	-----
	WRITTEN	EARNED	WRITTEN	EARNED
	-----	-----	-----	-----
Direct	\$242,912	\$211,590	\$206,625	\$171,955
Assumed	80,407	85,628	94,469	116,273
Ceded	(40,787)	(40,337)	(57,011)	(52,810)
	-----	-----	-----	-----
	\$282,532	\$256,881	\$244,083	\$235,418
	=====	=====	=====	=====

Assumed premiums primarily include all surety business written or renewed, net of reinsurance, by CCC and CIC, which is reinsured by Western Surety pursuant to reinsurance and related agreements.

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,			
	2005		2004	
	-----	-----	-----	-----
	\$	RATIO	\$	RATIO
	-----	-----	-----	-----
Gross losses and loss adjustment expenses ..	\$ 9,883	9.4%	\$ (6,177)	(6.2%)
Ceded amounts	10,093	(74.4%)	29,024	(172.1%)
	-----	-----	-----	-----
Net losses and loss adjustment expenses	\$19,976	21.9%	\$22,847	27.5%
	=====	-----	=====	-----

	NINE MONTHS ENDED SEPTEMBER 30,			
	2005		2004	
	-----	-----	-----	-----
	\$	RATIO	\$	RATIO
	-----	-----	-----	-----
Gross losses and loss adjustment expenses ..	\$106,682	35.9%	\$44,133	15.3%

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Ceded amounts	(2,352)	5.8%	20,552	(38.9%)
	-----		-----	
Net losses and loss adjustment expenses	\$104,330	40.6%	\$64,685	27.5%
	=====		=====	

11

During the three months ended September 30, 2005 and 2004, the Company recorded results based on independent actuarial reviews performed during the respective quarters which indicated that gross reserves should be reduced by approximately \$15 million and \$32 million, respectively, with a corresponding reduction in ceded reserves. This adjustment reflects changes in estimates of incurred-but-not-reported reserves. These actions resulted in the unusual relationships in the gross and ceded amounts shown above.

During the fourth quarter of 2004, the Company reached agreement with the claimant on a bond regarding certain aspects of the claim resolution. The bond was originally written by an affiliate and assumed by one of the Company's insurance subsidiaries pursuant to the Quota Share Treaty. As part of this agreement, the Company deposited \$32.7 million with the affiliate in the third quarter of 2005 to enable the affiliate to establish a trust to fund future payments under the bond. Such deposit is included on the balance sheet as "Deposit with affiliated ceding company". This claim was previously fully reserved.

2005 THIRD PARTY REINSURANCE COMPARED TO 2004 THIRD PARTY REINSURANCE

Effective January 1, 2005, CNA Surety entered into a new excess of loss treaty ("2005 Excess of Loss Treaty") with a group of third party reinsurers on terms similar to the 2004 Excess of Loss Treaty. Under the 2005 Excess of Loss Treaty, the Company's net retention per principal remains at \$10 million with a 5% co-participation in the \$90 million layer of third party reinsurance coverage above the Company's retention. The significant differences between the 2005 Excess of Loss Treaty and the Company's 2004 Excess of Loss Treaty are as follows. The annual aggregate coverage increases from \$157 million in 2004 to \$185 million in 2005. The base annual premium for the 2005 Excess of Loss Treaty is \$40.7 million compared to the actual cost of the 2004 Excess of Loss Treaty of \$50.6 million. The contract again includes an optional twelve month 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 in 2006 on bonds that were in force during 2005. In addition, the 2005 Excess of Loss Treaty provides coverage for one commercial principal that had been excluded from the 2004 Excess of Loss Treaty. The Company no longer has exposure to a second commercial principal that was excluded from the 2004 Excess of Loss Treaty. Only the large national contractor (described later) that was excluded from the 2004 Excess of Loss Treaty remains excluded from the 2005 Excess of Loss Treaty.

RELATED PARTY REINSURANCE

Reinsurance agreements together with the Services and Indemnity Agreement that are described below provide for the transfer of the surety business written by CCC and CIC to Western Surety.

The Services and Indemnity Agreement provides the Company's insurance subsidiaries the authority to perform various administrative, management, underwriting and claim functions in order to conduct the business of CCC and CIC

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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. This agreement was renewed on January 1, 2005 and expires on December 31, 2005 and is annually renewable thereafter.

Through a surety quota share treaty ("the Quota Share Treaty"), CCC and CIC transfer to Western Surety all surety business written or renewed by CCC and CIC after the Merger Date. The Quota Share Treaty was renewed on January 1, 2005 and expires on December 31, 2005 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 such business. This contemplates an approximate 4% override commission for fronting fees to CCC and CIC on their actual direct acquisition costs.

For the Quota Share Treaty in effect during 2004, the ceding commission paid to CCC and CIC by Western Surety was 28% of net written premiums. Due to lower commissions paid to producers on the business covered by the Quota Share Treaty, the actual override commission paid to CCC and CIC for 2004 was approximately 7%.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of September 30, 1997 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 September 30, 1997 (date of inception) through September 30, 2005.

Through a stop loss contract entered into at the Merger Date (the "Stop Loss Contract"), the Company's insurance subsidiaries were protected from adverse loss experience on certain business underwritten after the Merger Date. The Stop Loss Contract between the 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 exceeded 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 the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which their actual accident year net loss ratio exceeds the applicable Loss Ratio Cap, multiplied by (ii) the applicable net earned premiums. As of September 30, 2005, the Company had billed and received \$54.9 million

under the Stop Loss Contract. As a result of reevaluation and reduction of the net loss ratios for the accident years subject to the Stop Loss Contract, the Company has established a reinsurance payable to CCC of \$9.0 million under this contract at September 30, 2005.

The Company and CCC previously participated in a \$40 million excess of \$60 million reinsurance contract effective from January 1, 2004 to December 31, 2004 providing coverage exclusively for the one large national contractor that is excluded from the Company's third party reinsurance. The premium for this contract was \$3.0 million plus an additional premium of \$6.0 million if a loss is ceded under this contract. The Company and CCC entered into a new contract covering the large national contractor effective January 1, 2005 to December 31,

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2005 on the same terms as the 2004 contract. In the second quarter of 2005, this contract was amended to provide unlimited coverage in excess of the \$60 million retention, to increase the premium to \$7.0 million, and to eliminate the additional premium provision. This treaty provides coverage for the life of bonds either in force or written during the term of the treaty which is from January 1, 2005 to December 31, 2005. As of September 30, 2005, no losses have been ceded under this contract.

The Company and CCC entered into a new \$50 million excess of \$100 million contract for the period of January 1, 2004 to December 31, 2004. The premium for this contract was \$6.0 million plus an additional premium if a loss is ceded under this contract. Effective January 1, 2005, the Company and CCC entered into a new \$50 million excess of \$100 million contract in force through December 31, 2005. The premium for this contract was \$4.75 million plus an additional premium of \$14.0 million if a loss is ceded under this contract. In the second quarter of 2005, this contract was amended to exclude coverage for the large national contractor, to reduce the premium to \$3.0 million, and to reduce the additional premium to \$7.0 million. As of September 30, 2005, no losses have been ceded under this contract.

As of September 30, 2005 and December 31, 2004, CNA Surety had an insurance receivable balance from CCC and CIC of \$16.1 million and \$16.4 million. CNA Surety had reinsurance payables to CCC and CIC as of September 30, 2005 and December 31, 2004 of \$9.0 million and \$0.3 million.

LARGE NATIONAL CONTRACTOR

The Company has provided significant surety bond protection guaranteeing projects undertaken by the large national contract principal that is excluded from the Company's third party insurance. As previously described, during the second quarter of 2005, the Company and CCC executed amendments to the reinsurance treaties that provide reinsurance protection for losses associated with the large national contractor. Coverage for all losses in excess of an aggregate \$60 million is now provided under one treaty. Credit extended to the principal by affiliates of the Company are described below.

CNAF CREDIT FACILITY

Commencing in 2003, CNAF provided loans through a credit facility in order to help the large national contractor meet its liquidity needs and complete projects which had been bonded by CNA Surety. In December of 2004, the credit facility was amended to increase the maximum available loans to \$106 million from \$86 million at December 31, 2003. The amendment also provides that CNAF may in its sole discretion further increase the amounts available for loans under the credit facility, up to an aggregate maximum of \$126 million. As of September 30, 2005 and 2004, \$132 million (including accrued interest) and \$85 million (including accrued interest) had been advanced under the credit facility. Loews, through a participation agreement with CNAF, provided funds for and owned a participation of \$39.6 million and \$24.1 million of the loans outstanding as of September 30, 2005 and 2004, respectively, and has agreed to a participation of one-third of any additional loans which may be made above the original \$86 million credit facility limit up to the \$126 million maximum available line.

Loans under the credit facility are secured by a pledge of substantially all of the assets of the contractor and certain of its affiliates. In connection with the credit facility, CNAF has also guaranteed or provided collateral for letters of credit which are charged against the maximum available line and, if drawn upon, would be treated as loans under the credit facility. As of September 30, 2005 and December 31, 2004, these guarantees and collateral obligations were \$11 million and \$13 million, respectively.

The contractor implemented a restructuring plan intended to reduce costs

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and improve cash flow, and appointed a chief restructuring officer to manage execution of the plan. In the course of addressing various expense, operational and strategic issues, however, the contractor has decided to substantially reduce the scope of its original business and to concentrate on those segments determined to be potentially profitable. As a consequence, operating cash flow, and in turn the capacity to service debt, has been reduced below previous levels. Restructuring plans have also been extended to accommodate these circumstances. In light of these developments, CNAF recorded an impairment charge of \$56 million pre-tax for the fourth quarter of 2004, net of the participation by

13

Loews, with respect to amounts loaned under the credit facility and future impairment charges with respect to amounts loaned under the credit facility in 2005 of \$13 million pre-tax during the first quarter. Any future draws under the credit facility, if agreed to by CNAF pursuant to the additional credit facility amendment, or further changes in the large national contractor's business plan or projections may necessitate further impairment charges.

Representatives from the Company and CNAF met with senior management of the national contractor in June of 2005 to review their actual cash flow through that date, as well as expected future cash flow. As a result of the discussions with the contractor and after consideration of the contractor's overall performance to date under the restructuring plan, CNAF made a decision not to provide additional liquidity to the national contractor beyond amounts currently available under the existing facility. In addition, during the second quarter of 2005, CNAF recorded an additional impairment charge of \$21 million pre-tax.

ESTABLISHMENT OF SURETY LOSS RESERVE

The June 2005 discussions with the large national contractor revealed significant deterioration of the contractor's operations and cash flow. This deterioration was concentrated in an operating division of the contractor that had previously been placed into run off. As a result of these developments, the Company determined that the large national contractor will likely be unable to meet its obligations that are covered under the surety bonds. Accordingly, in the second quarter of 2005, the Company established a \$40 million loss reserve based on an initial estimate of probable surety losses. In the third quarter, the Company approved the payment by an affiliate, the direct writer of the surety bonds for the large national contractor, of approximately \$16 million of losses to settle outstanding bonded obligations of the contractor. The Company will reimburse the affiliate pursuant to the terms of the Quota Share Treaty. Also in the third quarter, the Company began a reevaluation of the contractor's current restructuring efforts. Possible changes to the restructuring strategy could result in higher loss estimates and result in additional reserve actions. The Company expects to complete this reevaluation in the fourth quarter.

The Company intends to continue to provide surety bonds on behalf of the contractor while re-evaluating the contractor's restructuring efforts, subject to the contractor's initial and ongoing compliance with the Company's underwriting standards. Indemnification and subrogation rights, including rights to contract proceeds on construction projects in the event of default, exist that reduce CNA Surety's exposure to loss. The Company estimates that possible additional losses, net of indemnification and subrogation recoveries but before recoveries under reinsurance contracts to be approximately \$160 million pre-tax. However, the related party reinsurance treaty discussed above would limit the Company's net loss exposure to an additional \$20 million. In establishing its overall reserves at September 30, 2005, the Company has contemplated the

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potential need for additional loss reserves related to this contractor as well as other potential exposures.

4. 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 EN SEPTEMBER 30	
	2005	2004	2005	2004
Reserves at beginning of period:				
Gross	\$402,769	\$412,367	\$363,387	\$413,367
Ceded reinsurance	114,212	160,419	116,831	158,419
Net reserves at beginning of period	288,557	251,948	246,556	254,948
Net incurred loss and loss adjustment expenses:				
Provision for insured events of current period	23,403	22,843	107,630	65,403
(Decrease) increase in provision for insured events of prior periods	(3,427)	4	(3,300)	
Total net incurred	19,976	22,847	104,330	64,403
Net payments attributable to:				
Current period events	1,444	1,320	2,375	2,375
Prior period events	3,099	23,012	44,521	66,012
Total net payments	4,543	24,332	46,896	68,387
Net reserves at end of period	303,990	250,463	303,990	250,463
Ceded reinsurance at end of period	101,957	126,937	101,957	126,937
Gross reserves at end of period	\$405,947	\$377,400	\$405,947	\$377,400

As a result of the independent actuarial review performed during the third quarter of 2005, the Company recorded net favorable reserve development of \$3.4 million for the three months ended September 30, 2005.

On January 2, 2003, CNA Surety settled litigation brought by J.P. Morgan Chase & Co. ("Chase") in connection with three surety bonds issued on behalf of Enron Corporation ("Enron") subsidiaries. The penal sums of the three bonds totaled approximately \$78 million. The Company paid Chase approximately \$40.7 million and assigned its recovery rights in the Enron bankruptcy to Chase in exchange for a full release of its obligations under the bonds. The Company has no other exposure related to the Enron Corporation. CNA Surety's net loss related to the settlement, after anticipated recoveries under excess of loss reinsurance treaties, was previously fully reserved. Immediately upon execution of the settlement documents, the Company sent written notice for reimbursement to its reinsurers. As of September 30, 2005, the Company billed a total of \$37.1

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million to its reinsurers. All nine reinsurers responsible for payment of the treaty proceeds either have paid their portions of the claim or paid the Company to commute the entire reinsurance treaty under which the Enron claim was made.

5. DEBT

On July 27, 2005, the Company refinanced \$30.0 million in outstanding borrowings under its previous credit facility with a new credit facility (the "2005 Credit Facility"). The 2005 Credit Facility provides an aggregate of up to \$50.0 million in borrowings under a revolving credit facility. The 2005 Credit Facility matures on June 30, 2008. No other debt matures in the next five years.

The term of borrowings under the 2005 Credit Facility may be fixed, at the Company's option, for a period of one, two, three, or six months. The interest rate is based on, among other rates, the London Interbank Offered Rate ("LIBOR") plus the applicable margin. The margin, including a facility fee and utilization fee, can vary based on the Company's leverage ratio (debt to total capitalization) from 1.15% to 1.45%. The margin was 1.30% at September 30, 2005. As of September 30, 2005, the weighted average interest rate on the 2005 Credit Facility was 4.98% on the \$30.0 million of outstanding borrowings.

The Company's previous credit facility (the "2002 Credit Facility"), as amended September 30, 2003, provided an aggregate of up to \$50.0 million in borrowings divided between a revolving credit facility of \$30.0 million and a term loan facility (the "Term Loan Facility") of \$20.0million. As of December 31, 2004, the weighted average interest rate on the 2002 Credit Facility was 3.28% on the \$35.0 million of outstanding borrowings.

The 2005 Credit Facility contains, among other conditions, limitations on the Company with respect to the incurrence of additional indebtedness and maintenance of a rating of at least "A-" by A.M. Best Co. for each of the Company's insurance subsidiaries. The 2005 Credit Facility also requires the maintenance of certain financial ratios as follows: a) maximum funded debt to total capitalization ratio of 25%, b) minimum net worth of \$375.0 million and c) minimum fixed charge coverage ratio of 2.5 times. The Company was in compliance with all covenants for the quarter ended September 30, 2005.

Due to the net loss reported in the quarter ended June 30, 2005, the Company did not meet the minimum fixed charge coverage ratio of 2.5 times as of June 30, 2005 as required by the 2002 Credit Facility. This issue was resolved as a result of the replacement of the 2002 Credit Facility with the 2005 Credit Facility.

In May of 2004, the Company, through a wholly-owned trust, privately issued \$30.0 million of preferred securities through two pooled transactions. These securities bear interest at a rate of LIBOR plus 337.5 basis points with a 30-year term and are redeemable after five years. The securities were issued by CNA Surety Capital Trust I (the "Issuer Trust"). The sole asset of the Issuer Trust consists of a \$30.9 million junior subordinated debenture issued by the Company to the Issuer Trust. 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 \$75.0 million, consisting of annual dividend payments of \$1.5 million over 30 years and the redemption value 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 subordinated debenture bears interest at a rate of LIBOR plus 337.5 basis points and matures in April of 2034. As of September 30, 2005 the interest rate on the junior subordinated debenture was 7.17%.

6. EMPLOYEE BENEFITS

CNA Surety established the CNA Surety Corporation Deferred Compensation Plan ("Plan"), effective April 1, 2000. The Company established and maintains the Plan as an unfunded, nonqualified deferred compensation plan for a select group of management or highly compensated employees. The purpose of the Plan is to permit designated employees of the Company and participating affiliates to accumulate additional retirement income through a nonqualified deferred compensation plan that enables them to defer compensation to which they will become entitled in the future.

On April 25, 2005, the Board of Directors of CNA Surety Corporation approved the CNA Surety Corporation 2005 Deferred Compensation Plan (the "Plan") and the CNA Surety Corporation 2005 Deferred Compensation Plan Trust (the "Trust"). The Plan and Trust were adopted in connection with the enactment of Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"), which was implemented under the American Jobs Creation Act of 2004. The Plan and Trust will be used in lieu of the CNA Surety Corporation Deferred Compensation Plan (the "Existing Plan") and the CNA Surety Corporation Deferred Compensation Plan Trust (the "Existing Trust") for all amounts deferred on or after January 1, 2005. Amounts deferred under the Existing Plan prior to January 1, 2005 will continue to be covered by and paid out in accordance with the terms of the Existing Plan, the Existing Trust and the elections made by participants under the Existing Plan.

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 postretirement health care 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.

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,	
	2005	2004	2005	2004
Net periodic benefit cost:				
Service cost	\$107	\$ 38	\$ 181	\$ 112
Interest cost	233	84	382	254
Prior service cost	(40)	(40)	(121)	(121)
Recognized net actuarial (gain) loss ..	145	(1)	145	(3)
	----	----	-----	-----
Net periodic benefit cost	\$445	\$ 81	\$ 587	\$ 242
	=====	=====	=====	=====

The Company expects to contribute \$0.3 million to the postretirement benefit plans to pay benefits in 2005. As of September 30, 2005, \$0.1 million of contributions have been made to the postretirement benefit plans.

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As of December 31, 2004, the financial statements of the Company reflect the effects of the Medicare Modernization Act ("MMA") on the Western Surety retiree medical plan in accordance with FASB Staff Position 106-2. Western Surety is expected to receive a direct subsidy under MMA which is treated as a reduction in expected net benefit payments. The estimated effect on annual benefit cost in 2005 is a reduction in service cost of \$36,000, a reduction in interest cost of \$71,000, and an increase in the amortization of unrecognized gains of \$83,000, for a total reduction in annual net periodic postretirement benefit cost of \$190,000.

7. COMMITMENTS AND CONTINGENCIES

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

16

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, 2004.

CRITICAL ACCOUNTING POLICIES

Management believes the most significant accounting policies and related disclosures for purposes of understanding the Company's results of operations and financial condition pertain to reserves for unpaid losses and loss adjustment expenses and reinsurance, investments, intangible assets, and deferred policy acquisition costs. The Company's accounting policies related to reserves 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. These balances are highly subjective and require management's most complex judgments because of the need to make estimates about the effects of matters that are inherently uncertain.

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

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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 estimate 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 file, some estimates need to be adjusted during the life cycle of the file as matters continue to develop. Factors that can necessitate case estimate 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 following table shows the estimated liability as of September 30, 2005 for unpaid claims applicable to reported claims and to IBNR (dollars in thousands) for each sub-line of business:

	GROSS CASE LOSS AND LAE RESERVES	GROSS IBNR LOSS AND LAE RESERVES	TOTAL GROSS RESERVES
	-----	-----	-----
Contract.....	\$ 98,773	\$136,781	\$235,554
Commercial.....	100,955	57,730	158,685
Fidelity and other...	4,363	7,345	11,708
	-----	-----	-----
Total.....	\$204,091	\$201,856	\$405,947
	=====	=====	=====

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, 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.

The Company's Condensed Consolidated Balance Sheets includes estimated liabilities for unpaid losses and loss adjustment expenses of \$405.9 million and \$363.4 million and reinsurance receivables related to unpaid losses of \$102.0 million and \$116.8 million at September 30, 2005 and December 31, 2004, respectively. Due to the inherent uncertainties in the process of establishing

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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 classifies all of its fixed income securities (bonds and redeemable preferred stocks) 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 as a separate component of other comprehensive income. Cash flows from purchases, sales and maturities 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 and the cumulative effect of amortization of premiums and accretion of discounts to maturity. Such amortization and accretion are included in investment income. For mortgage-backed and certain asset-backed securities, the Company recognizes income using the effective-yield method based on estimated cash flows. All securities transactions are recorded on the trade date. Investment gains or losses realized on the sale of securities are determined using the specific identification method. Investments with an other-than-temporary decline in value are written down to fair value, resulting in losses that are included in realized investment gains and losses.

Short-term investments, which generally include U.S. Treasury bills, corporate notes, money market funds, and investment grade commercial paper equivalents, are carried at amortized cost that 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 significantly affect the amounts reported in the Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Income.

INTANGIBLE ASSETS

CNA Surety's Condensed Consolidated Balance Sheet as of September 30, 2005 and December 31, 2004 includes intangible assets of approximately \$138.8 million. These amounts represent goodwill and identified intangibles arising from the acquisition of Capsure Holdings Corp. ("Capsure"). Prior to 2002, goodwill from this and other acquisitions was generally amortized as a charge to earnings over periods not exceeding 30 years. Under Statement of Financial Accounting Standards ("SFAS") No. 142 entitled "Goodwill and Other Intangible Assets" ("SFAS No. 142"), which was adopted by CNA Surety as of January 1, 2002, periodic amortization ceased, in accordance with an impairment-only accounting model.

A significant amount of judgment is required in performing intangible assets impairment tests. Such tests are performed annually on October 1, or more frequently if events or changes indicate that the estimated fair value of CNA Surety's reporting units might be impaired. Under SFAS No. 142, fair value refers to the amount for which the entire reporting unit may be bought or sold. 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. If the carrying

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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.

DEFERRED POLICY ACQUISITION 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

18

the related premiums are earned. The Company periodically tests that deferred 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 acquisition costs, a charge to net income is taken and the deferred 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 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. The Company's investment portfolio is monitored through analysis of various quantitative and qualitative factors and certain decisions related to the sale or impairment of investments that produce realized gains and losses, which is also a component used in the calculation of net income and is a non-GAAP financial measure.

Underwriting results are computed as net earned premiums less net loss 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 loss 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")

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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 acquisition costs, to net earned premiums. The combined ratio is the sum of the loss and expense ratios.

The Company's investment portfolio is monitored by management through analysis of various factors including unrealized gains and losses on securities, portfolio duration and exposure to interest rates, and market and credit risk. Based on such analyses, the Company may impair an investment security in accordance with its policy, or sell a security. Such activities will produce net realized investment gains and losses.

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 RESULTS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004

ANALYSIS OF NET INCOME

Net income for the three months ended September 30, 2005 was \$19.8 million, compared to a net income of \$11.0 million for the same period in 2004. This increase is a result of higher net earned premium, higher net investment income, and the impacts of lower loss and expense ratios. The lower loss ratio reflects favorable loss development on prior accident years of \$3.4 million.

Net income for the nine months ended September 30, 2005 was \$21.9 million compared to \$27.5 million for the same period in 2004. The decrease reflects higher losses in large part due to the establishment of a \$40 million loss reserve related to the large

19

national contractor in the second quarter of 2005, partially offset by higher net earned premium and higher net investment income. The decrease was also offset by favorable loss development on prior accident years of \$3.3 million.

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, 2005 and 2004 are summarized in the following table (dollars in thousands):

THREE MONTHS ENDED SEPTEMBER 30,	NINE MONTHS ENDED SEPTEMBER 30,
-----	-----

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	2005	2004	2005	2004
	-----	-----	-----	-----
Gross written premiums.....	\$113,482	\$102,151	\$323,319	\$301,094
	=====	=====	=====	=====
Net written premiums.....	\$103,031	\$ 86,417	\$282,532	\$244,083
	=====	=====	=====	=====
Net earned premiums.....	\$ 91,061	\$ 83,068	\$256,881	\$235,418
	=====	=====	=====	=====
Net losses and loss adjustment expenses...	\$ 19,976	\$ 22,847	\$104,330	\$ 64,685
	=====	=====	=====	=====
Net commissions, brokerage and other expenses.....	\$ 51,891	\$ 52,245	\$150,593	\$156,627
	=====	=====	=====	=====
Loss ratio.....	21.9%	27.5%	40.6%	27.5%
Expense ratio.....	57.0	62.9	58.6	66.5
	-----	-----	-----	-----
Combined ratio.....	78.9%	90.4%	99.2%	94.0%
	=====	=====	=====	=====

PREMIUMS WRITTEN

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.

The Company assumes significant amounts of premiums primarily from affiliates. This includes all surety business written or renewed, net of reinsurance, by CCC and CIC, and their affiliates, after the Merger Date 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 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.

Gross written premiums are summarized in the following table (dollars in thousands):

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	-----	-----	-----	-----
	2005	2004	2005	2004
	-----	-----	-----	-----
Contract.....	\$ 71,044	\$ 61,610	\$194,179	\$172,807
Commercial.....	33,568	32,548	102,069	103,877
Fidelity and other.....	8,870	7,993	27,071	24,410
	-----	-----	-----	-----
	\$113,482	\$102,151	\$323,319	\$301,094

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Gross written premiums increased 11.1% to \$113.5 million, for the three months ended September 30, 2005 as compared with the same period in 2004. Contract surety gross written premiums increased 15.3% to \$71.0 million due primarily to increased volume. Commercial surety gross written premiums increased 3.1% to \$33.6 million due to continued volume growth in small commercial products, partially offset by declining premium volume on large commercial accounts. Fidelity and other premiums increased by 11.0% primarily due to the volume growth of related small commercial products.

Gross written premiums increased 7.4%, or \$22.2 million, for the nine months ended September 30, 2005 as compared with the same period in 2004. This increase was primarily a result of a 12.4% or \$21.4 million, increase in contract surety as compared with the same period in 2004, due to volume growth. Commercial surety decreased 1.7%, or \$1.8 million, as continued strong volume growth

20

in small commercial products was more than offset by declining premium volume on large commercial accounts. Fidelity and other premiums increased by 10.9% primarily due to the volume growth of related small commercial products.

Net written premiums are summarized in the following table (dollars in thousands):

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2005	2004	2005	2004
Contract.....	\$ 61,732	\$45,775	\$157,847	\$130,384
Commercial.....	32,429	33,015	97,614	90,375
Fidelity and other...	8,870	7,627	27,071	23,324
	-----	-----	-----	-----
	\$103,031	\$86,417	\$282,532	\$244,083
	=====	=====	=====	=====

Net written premiums increased 19.2% or \$16.6 million, for the three months ended September 30, 2005 as compared with the same period in 2004, primarily due to the increase in gross written premiums as described above and a decrease in ceded written premiums. Ceded written premiums decreased \$5.3 million for the three months ended September 30, 2005 as compared with the same period in 2004, reflecting the reduction in the cost of the Company's 2005 reinsurance program.

For the nine months ended September 30, 2005, net written premiums increased 15.8%, or \$38.4 million, as compared with the same period in 2004, primarily due to the increase in gross written premiums as described above and a decrease in ceded written premiums. Ceded written premiums decreased \$16.2 million for the nine months ended September 30, 2005 as compared with the same period in 2004, reflecting the reduction in the cost of the Company's 2005 reinsurance program. Net written premiums increased 17.8%, or \$23.8 million, for contract surety and 12.6%, or \$10.9 million, for commercial surety for the nine

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months ended September 30, 2005 as compared with the same period in 2004. Net written premiums increased 16.1%, or \$3.7 million, for fidelity and other products for the nine months ended September 30, 2005 as compared with the same period in 2004.

EXCESS OF LOSS REINSURANCE

The Company's 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.

2005 THIRD PARTY REINSURANCE COMPARED TO 2004 THIRD PARTY REINSURANCE

Effective January 1, 2005, CNA Surety entered into a new excess of loss treaty ("2005 Excess of Loss Treaty") with a group of third party reinsurers on terms similar to the 2004 Excess of Loss Treaty. Under the 2005 Excess of Loss Treaty, the Company's net retention per principal remains at \$10 million with a 5% co-participation in the \$90 million layer of third party reinsurance coverage above the Company's retention. The significant differences between the 2005 Excess of Loss Treaty and the Company's 2004 Excess of Loss Treaty are as follows. The annual aggregate coverage increases from \$157 million in 2004 to \$185 million in 2005. The base annual premium for the 2005 Excess of Loss Treaty is \$40.7 million compared to the actual cost of the 2004 Excess of Loss Treaty of \$50.6 million (net of expected return premium). The contract again includes an optional twelve month 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 in 2006 on bonds that were in force during 2005. In addition, the 2005 Excess of Loss Treaty provides coverage for one commercial principal that had been excluded from the 2004 Excess of Loss Treaty. The Company no longer has exposure to a second commercial principal that was excluded from the 2004 Excess of Loss Treaty. Only the large national contractor (described later) that was excluded from the 2004 Excess of Loss Treaty remains excluded from the 2005 Excess of Loss Treaty.

RELATED PARTY REINSURANCE

Reinsurance agreements together with the Services and Indemnity Agreement that are described below provide for the transfer of the surety business written by CCC and CIC to Western Surety.

The Services and Indemnity Agreement provides the Company's insurance subsidiaries the authority to perform various administrative, management, underwriting and claim functions in order to conduct the 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. This agreement was renewed on January 1, 2005 and expires on December 31, 2005 and is annually renewable thereafter.

Through a surety quota share treaty (the "Quota Share Treaty"), CCC and CIC transfer to Western Surety all surety business written or renewed by CCC and CIC after the Merger Date. The Quota Share Treaty was renewed on January 1, 2005 and expires on December 31, 2005 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 such business. This

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contemplates an approximate 4% override commission for fronting fees to CCC and CIC on their actual direct acquisition costs.

For the quota share treaty in effect during 2004, the ceding commission paid to CCC and CIC by Western Surety was 28% of net written premiums. Due to lower commissions paid to producers on the business covered by the Quota Share Treaty, the actual override commission paid to CCC and CIC for 2004 was approximately 7%.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of September 30, 1997 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 September 30, 1997 (date of inception) through September 30, 2005.

Through a stop loss contract entered into at the Merger Date (the "Stop Loss Contract"), the Company's insurance subsidiaries were protected from adverse loss experience on certain business underwritten after the Merger Date. The Stop Loss Contract between the 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 exceeded 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 the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which their actual accident year net loss ratio exceeds the applicable Loss Ratio Cap, multiplied by (ii) the applicable net earned premiums. As of September 30, 2005, the Company had billed and received \$54.9 million under the Stop Loss Contract. As a result of reevaluation and reduction of the net loss ratios for the accident years subject to the Stop Loss Contract, the Company has established a reinsurance payable to CCC of \$9.0 million under this contract at September 30, 2005.

The Company and CCC previously participated in a \$40 million excess of \$60 million reinsurance contract effective from January 1, 2004 to December 31, 2004 providing coverage exclusively for the one large national contractor that is excluded from the Company's third party reinsurance. The premium for this contract was \$3.0 million plus an additional premium of \$6.0 million if a loss is ceded under this contract. The Company and CCC entered into a new contract covering the large national contractor effective January 1, 2005 to December 31, 2005 on the same terms as the 2004 contract. In the second quarter of 2005, this contract was amended to provide unlimited coverage in excess of the \$60 million retention, to increase the premium to \$7.0 million, and to eliminate the additional premium provision. This treaty provides coverage for the life of bonds either in force or written during the term of the treaty which is from January 1, 2005 to December 31, 2005. As of September 30, 2005, no losses have been ceded under this contract.

The Company and CCC entered into a new \$50 million excess of \$100 million contract for the period of January 1, 2004 to December 31, 2004. The premium for this contract was \$6.0 million plus an additional premium if a loss is ceded under this contract. Effective January 1, 2005, the Company and CCC entered into a new \$50 million excess of \$100 million contract in force through December 31, 2005. The premium for this contract was \$4.75 million plus an additional premium of \$14.0 million if a loss is ceded under this contract. In the second quarter of 2005, this contract was amended to exclude coverage for the large national contractor, to reduce the premium to \$3.0 million, and to reduce the additional premium to \$7.0 million. As of September 30, 2005, no losses have been ceded under this contract.

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LARGE NATIONAL CONTRACTOR

The Company has provided significant surety bond protection guaranteeing projects undertaken by the large national contract principal that is excluded from the Company's third party insurance. As previously described, during the second quarter of 2005, the Company and CCC executed amendments to the reinsurance treaties that provide reinsurance protection for losses associated with the large national contractor. Coverage for all losses in excess of an aggregate \$60 million is now provided under one treaty. Credit extended to the principal by affiliates of the Company are described below.

22

CNAF CREDIT FACILITY

Commencing in 2003, CNAF provided loans through a credit facility in order to help the large national contractor meet its liquidity needs and complete projects which had been bonded by CNA Surety. In December of 2004, the credit facility was amended to increase the maximum available loans to \$106 million from \$86 million at December 31, 2003. The amendment also provides that CNAF may in its sole discretion further increase the amounts available for loans under the credit facility, up to an aggregate maximum of \$126 million. As of September 30, 2005 and 2004, \$132 million (including accrued interest) and \$85 million (including accrued interest) had been advanced under the credit facility. Loews, through a participation agreement with CNAF, provided funds for and owned a participation of \$39.6 million and \$24.1 million of the loans outstanding as of September 30, 2005 and 2004, respectively, and has agreed to a participation of one-third of any additional loans which may be made above the original \$86 million credit facility limit up to the \$126 million maximum available line.

Loans under the credit facility are secured by a pledge of substantially all of the assets of the contractor and certain of its affiliates. In connection with the credit facility, CNAF has also guaranteed or provided collateral for letters of credit which are charged against the maximum available line and, if drawn upon, would be treated as loans under the credit facility. As of September 30, 2005 and December 31, 2004, these guarantees and collateral obligations were \$11 million and \$13 million, respectively.

The contractor implemented a restructuring plan intended to reduce costs and improve cash flow, and appointed a chief restructuring officer to manage execution of the plan. In the course of addressing various expense, operational and strategic issues, however, the contractor has decided to substantially reduce the scope of its original business and to concentrate on those segments determined to be potentially profitable. As a consequence, operating cash flow, and in turn the capacity to service debt, has been reduced below previous levels. Restructuring plans have also been extended to accommodate these circumstances. In light of these developments, CNAF recorded an impairment charge of \$56 million pre-tax (\$36 million after-tax) for the fourth quarter of 2004, net of the participation by Loews, with respect to amounts loaned under the credit facility and future impairment charges with respect to amounts loaned under the credit facility in 2005 of \$13 million pre-tax (\$9 million after-tax) during the first quarter. Any future draws under the credit facility, if agreed to by CNAF pursuant to additional credit facility amendment, or further changes in the large national contractor's business plan or projections may necessitate further impairment charges.

Representatives from the Company and CNAF met with senior management of the national contractor in June of 2005 to review their actual cash flow through

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that date, as well as expected future cash flow. As a result of the discussions with the contractor and after consideration of the contractor's overall performance to date under the restructuring plan, CNAF made a decision not to provide additional liquidity to the national contractor beyond amounts currently available under the existing facility. In addition, during the second quarter of 2005, CNAF recorded an additional impairment charge of \$21 million pre-tax (\$13 million after-tax).

ESTABLISHMENT OF SURETY LOSS RESERVE

The June 2005 discussions with the large national contractor revealed significant deterioration of the contractor's operations and cash flow. This deterioration was concentrated in an operating division of the contractor that had previously been placed into run off. As a result of these developments, the Company determined that the large national contractor will likely be unable to meet its obligations that are covered under the surety bonds. Accordingly, in the second quarter of 2005, the Company established a \$40 million loss reserve based on an initial estimate of probable surety losses. In the third quarter, the Company approved the payment by an affiliate, the direct writer of the surety bonds for the large national contractor, of approximately \$16 million of losses to settle outstanding bonded obligations of the contractor. The Company will reimburse the affiliate pursuant to the terms of the Quota Share Treaty. Also in the third quarter, the Company began a reevaluation of the contractor's current restructuring efforts. Possible changes to the restructuring strategy could result in higher loss estimates and result in additional reserve actions. The Company expects to complete this reevaluation in the fourth quarter.

The Company intends to continue to provide surety bonds on behalf of the contractor while re-evaluating the contractor's restructuring efforts, subject to the contractor's initial and ongoing compliance with the Company's underwriting standards. Indemnification and subrogation rights, including rights to contract proceeds on construction projects in the event of default, exist that reduce CNA Surety's exposure to loss. The Company estimates that possible additional losses, net of indemnification and subrogation recoveries but before recoveries under reinsurance contracts to be approximately \$160 million pre-tax. However, the related party reinsurance treaty discussed above would limit the Company's net loss exposure to an additional \$20 million. In establishing its overall reserves at September 30, 2005, the Company has contemplated the potential need for additional loss reserves related to this contractor as well as other potential exposures.

23

The Company has had discussions with its insurance regulatory authorities regarding the level of bonds provided for this principal and will continue to keep the insurance regulators informed of its ongoing exposure to this account.

NET LOSS RATIO

The net loss ratio was 21.9% for the three months ended September 30, 2005 as compared with 27.5% for the same period in 2004. The lower loss ratio reflects the favorable development on prior accident years of \$3.4 million, or approximately 4 percentage points, and lower loss estimates for the current accident year due to improved loss experience. The loss ratio also benefited from an increase in net earned premium that resulted from the reduction in the cost of the Company's 2005 reinsurance program.

The net loss ratio was 40.6% for the nine months ended September 30, 2005 as compared with 27.5% for the same period in 2004. The increase in the loss

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ratio reflects the reserve charge of \$40 million related to the large national contractor, which added 16 percentage points to this ratio. This was partially offset by favorable development on prior accident years of \$3.3 million and an increase in net earned premium that resulted from the reduction in the cost of the Company's 2005 reinsurance program.

On January 2, 2003, CNA Surety settled litigation brought by J.P. Morgan Chase & Co. ("Chase") in connection with three surety bonds issued on behalf of Enron Corporation ("Enron") subsidiaries. The penal sums of the three bonds totaled approximately \$78 million. The Company paid Chase approximately \$40.7 million and assigned its recovery rights in the Enron bankruptcy to Chase in exchange for a full release of its obligations under the bonds. The Company has no other exposure related to the Enron Corporation. CNA Surety's net loss related to the settlement, after anticipated recoveries under excess of loss reinsurance treaties, was previously fully reserved. Immediately upon execution of the settlement documents, the Company sent written notice for reimbursement to its reinsurers. As of September 30, 2005, the Company billed a total of \$37.1 million to its reinsurers. All nine reinsurers responsible for payment of the treaty proceeds either have paid their portions of the claim or paid the Company to commute the entire reinsurance treaty under which the Enron claim was made.

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 continues with various exposure management initiatives, particularly to reduce its risks on large commercial accounts. "Exposure" is defined as the face amount of the bond. As the following table depicts, the Company has reduced its total exposure, before the effects of reinsurance, by 26.8% in 2005 on large commercial accounts, which are defined as accounts with exposures in excess of \$10 million:

	NUMBER OF ACCOUNTS AS OF		TOTAL EXPOSURE (DOLLARS IN MILLION) AS OF		% INC (DEC)
	SEPTEMBER 30, 2005	DECEMBER 31, 2004	SEPTEMBER 30, 2005	DECEMBER 31, 2004	
COMMERCIAL ACCOUNT EXPOSURE					
\$100 million and larger	2	2	\$ 247.8	\$ 256.4	(3)
\$50 to \$100 million	2	7	139.6	468.1	(70)
\$25 to \$50 million	10	11	355.4	401.0	(11)
\$10 to \$25 million	36	39	500.8	572.5	(12)
	---	---	-----	-----	---
Total	50	59	\$1,243.6	\$1,698.0	(26)
	===	===	=====	=====	===

The Company expects to continue to reduce its risks on large commercial accounts, but the rate of this reduction is expected to slow.

With respect to contract surety, the Company's portfolio is predominantly comprised of contractors with bonded backlog of less than \$30 million. Bonded backlog is a measure of the Company's exposure in the event of default before indemnification, salvage and subrogation recoveries. The Company does have a number of accounts with higher bonded backlogs. For example, the Company has 15 accounts each with a bonded backlog in excess of \$150 million and 20 accounts each with a bonded backlog of between \$100 million and \$150 million.

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The Company continues to manage 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, indemnification and subrogation rights, including rights to contract proceeds on construction projects in the event of default, exist that substantially reduce CNA Surety's exposure to loss.

24

EXPENSE RATIO

The expense ratio was 57.0% for the three months ended September 30, 2005 as compared with 62.9% for the same period in 2004. Approximately two percentage points of this improvement resulted from the impact of the reduction in cost of the Company's 2005 reinsurance program. The remaining improvement resulted from premium volume growth and the impacts of cost reduction initiatives that began in the first quarter of 2004.

The expense ratio was 58.6% for the nine months ended September 30, 2005 as compared with 66.5% for the same period in 2004. Approximately three percentage points of this improvement resulted from the impact of the reduction in cost of the Company's 2005 reinsurance program. The improved expense ratio also reflects higher premium volume and the impacts of cost reduction initiatives to simplify and streamline the field organization that began in the first quarter of 2004. The improved expense ratio also reflects the absence of expenses associated with the cost reduction initiatives and the increased accrual for policyholder dividends that were recorded in the first quarter of 2004. These items added 2.9 percentage points to the expense ratio for the first nine months of 2004.

INVESTMENT INCOME AND REALIZED INVESTMENT GAINS/LOSSES

Net investment income was \$8.7 million for the three months ended September 30, 2005, as compared with \$7.7 million for the same period in 2004. This is due to the significant increase in invested assets. The annualized pre-tax yield was 4.3% for both the three months ended September 30, 2005 and 2004. The annualized after-tax yield was 3.6% for both the three months ended September 30, 2005 and 2004. Net realized investment gains were negligible for both the three months ended September 30, 2005 and 2004.

Net investment income was \$24.7 million for the nine months ended September 30, 2005 as compared with \$22.1 million for the same period in 2004. The increase is due to the impact of higher overall invested assets, partially offset by slightly lower yields. The annualized pre-tax yields were 4.3% and 4.4% for the nine months ended September 30, 2005 and 2004, respectively. The annualized after-tax yield was 3.6% and 3.7% for the nine months ended September 30, 2005 and 2004, respectively. Net realized investment gains were \$2.1 million for the nine months ended September 30, 2005 as compared with \$2.5 million for the same period in 2004. The realized investment gain in 2005 resulted primarily from the Company's sale of its interest in DeMontfort Group, Ltd. in the first quarter of 2005.

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

THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
-----		-----	
2005	2004	2005	2004

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	----	----	-----	-----
Gross realized investment gains....	\$109	\$194	\$2,280	\$2,481
Gross realized investment losses...	(1)	-	(156)	(5)
	----	----	-----	-----
Net realized investment gains.....	\$108	\$194	\$2,124	\$2,476
	=====	=====	=====	=====

The Company's investment portfolio generally is 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.

Invested assets are exposed to various risks, such as interest rate, market and credit. 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.

INTEREST EXPENSE

Interest expense increased by 41.3% for the three months ended September 30, 2005 as compared with the same period in 2004, due to higher interest rates associated with the Credit Facility and the subordinated debentures issued in the second quarter of 2004. Weighted average debt outstanding was \$60.9 million for the three months ended September 30, 2005 as compared with \$66.0 million for the same period in 2004. The weighted average interest rate for the three months ended September 30, 2005 was 5.9% as compared with 3.8% for the same period in 2004.

25

Interest expense also increased slightly for the nine months ended September 30, 2005 as compared with the same period in 2004. Average debt outstanding was \$62.6 million for the nine months ended September 30, 2005 compared to \$59.2 million in the same period in 2004. The weighted average interest rate for the nine months ended September 30, 2005 was 5.3% as compared with 3.3% for the same period in 2004.

INCOME TAXES

For the three and nine months ended September 30, 2004 and 2005, the Company's effective tax rate differs from the statutory tax rate due primarily to tax exempt investment income. The impact of tax exempt securities on taxable income was \$4.1 million and \$12.1 million for the three and nine months ended September 30, 2005. The impact of tax exempt securities on taxable income was \$3.6 million and \$10.7 million for the three and nine months ended September 30, 2004.

LIQUIDITY AND CAPITAL RESOURCES

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It is anticipated that the liquidity requirements of CNA Surety will be met primarily with funds generated from its insurance operations. The principal sources of consolidated cash flows are premiums, investment income, sales and maturities of investments, and reinsurance recoveries. CNA Surety also may generate funds from additional borrowings under the credit facility described below. The primary cash flow uses are payments for claims, operating expenses, reinsurance premiums, 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. At September 30, 2005, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of \$710.9 million of fixed income securities, \$77.0 million of short-term investments, \$1.0 million of other investments and \$4.6 million of cash. At December 31, 2004, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of \$722.0 million of fixed income securities, \$22.7 million of short-term investments, \$1.1 million of other investments and \$5.6 million of cash.

During the fourth quarter of 2004, the Company reached agreement with the claimant on a bond regarding certain aspects of the claim resolution. The bond was originally written by an affiliate and assumed by one of the Company's insurance subsidiaries pursuant to the Quota Share Treaty. As part of this agreement, the Company deposited \$32.7 million with the affiliate in the third quarter of 2005 to enable the affiliate to establish a trust to fund future payments under the bond. Such deposit is included on the Company's Condensed Consolidated Balance Sheets as "Deposit with affiliated ceding company". This claim was previously fully reserved. The Company is entitled to the interest income earned by the trust in excess of trust expenses.

Cash flow at the parent company level is derived principally from dividend and tax sharing payments from its insurance subsidiaries. The principal obligations at the parent company level are to service debt and pay operating expenses, including income taxes. At September 30, 2005, the parent company's invested assets consisted of \$1.0 million of fixed income securities, \$1.2 million of equity securities, \$14.6 million of short-term investments and \$1.7 million of cash. At December 31, 2004, the parent company's invested assets consisted of \$6.3 million of fixed income securities, \$1.2 million of equity securities, \$5.8 million of short-term investments and \$1.7 million of cash. At September 30, 2005 and December 31, 2004 respectively, parent company short-term investments and cash included \$2.9 million and \$5.1 million of restricted cash 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 \$12.5 million for the three months ended September 30, 2005 compared to net cash flow provided by operating activities of \$44.2 million for the comparable period in 2004. The decrease in net cash flow provided by operating activities primarily relates to the Company's deposit with an affiliate to establish the trust discussed above.

The Company's consolidated net cash flow provided by operating activities was \$68.1 million for the nine months ended September 30, 2005 compared to net cash flow provided by operating activities of \$103.5 million for the comparable period in 2004. The decrease in net cash flow provided by operating activities primarily relates to the Company's deposit with an affiliate to establish the trust discussed above.

On July 27, 2005, the Company refinanced \$30.0 million in outstanding borrowings under its previous credit facility with a new credit facility (the "2005 Credit Facility"). The 2005 Credit Facility provides an aggregate of up to \$50.0 million in borrowings under a revolving credit facility. The 2005 Credit Facility matures on June 30, 2008. No other debt matures in the next five years.

The term of the borrowings under the 2005 Credit Facility may be fixed, at the Company's option, for a period of one, two, three, or six months. The interest rate is based on, among other rates, the London Interbank Offered Rate ("LIBOR") plus the applicable margin. The margin, including a facility fee and utilization fee, can vary based on the Company's leverage ratio (debt to total capitalization) from 1.15% to 1.45%. The margin was 1.30% at September 30, 2005. As of September 30, 2005, the weighted average interest rate on the 2005 Credit Facility was 4.98% on the \$30.0 million of outstanding borrowings.

The Company's previous credit facility (the "2002 Credit Facility"), as amended September 30, 2003, provided an aggregate of up to \$50.0 million in borrowings divided between a revolving credit facility of \$30.0 million and a term loan facility (the "Term Loan Facility") of \$20.0million. As of December 31, 2004, the weighted average interest rate on the 2002 Credit Facility was 3.28% on the \$35.0 million of outstanding borrowings.

The 2005 Credit Facility contains, among other conditions, limitations on the Company with respect to the incurrence of additional indebtedness and maintenance of a rating of at least "A-" by A.M. Best Co. for each of the Company's insurance subsidiaries. The 2005 Credit Facility also requires the maintenance of certain financial ratios as follows: a) maximum funded debt to total capitalization ratio of 25%, b) minimum net worth of \$375.0 million and c) minimum fixed charge coverage ratio of 2.5 times. The Company is in compliance with all covenants during the quarter ended September 30, 2005.

Due to the net loss reported in the quarter ended June 30, 2005, the Company did not meet the minimum fixed charge coverage ratio of 2.5 times as of June 30, 2005 as required by the 2002 Credit Facility. This issue was resolved as a result of the replacement of the 2002 Credit Facility with the 2005 Credit Facility.

In May of 2004, the Company, through a wholly-owned trust, privately issued \$30.0 million of preferred securities through two pooled transactions. These securities bear interest at a rate of LIBOR plus 337.5 basis points with a 30-year term and are redeemable after five years. The securities were issued by CNA Surety Capital Trust I (the "Issuer Trust"). The sole asset of the Issuer Trust consists of a \$30.9 million junior subordinated debenture issued by the Company to the Issuer Trust. 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 \$75.0 million, consisting of annual dividend payments of \$1.5 million over 30 years and the redemption value 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 subordinated debenture bears interest at a rate of LIBOR plus 337.5 basis points and matures in April of 2034. As of September 30, 2005 the interest rate on the junior subordinated debenture was 7.17%.

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A summary of the Company's commitments as of September 30, 2005 is presented in the following table (in millions):

SEPTEMBER 30, 2005 -----	2005 -----	2006 -----	2007 -----	2008 -----	2009 -----	THEREAFTER -----
Debt (a).....	\$ 0.8	\$ 3.7	\$ 3.7	\$33.2	\$ 2.2	\$ 85.1
Operating leases.....	0.5	1.9	1.7	1.5	1.5	3.8
Loss and loss adjustment expense reserves..	72.3	157.2	69.9	29.5	21.1	55.9
Other long-term liabilities (b).....	0.2	0.3	0.4	0.4	0.4	6.4
	-----	-----	-----	-----	-----	-----
Total.....	\$73.8	\$163.1	\$75.7	\$64.6	\$25.2	\$151.2
	=====	=====	=====	=====	=====	=====

(a) Reflects expected principal and interest payments.

(b) Reflects post-employment obligations to former executives and unfunded post-retirement benefit plans.

As an insurance holding company, CNA Surety is dependent upon dividends and other permitted payments from its insurance subsidiaries to pay operating expenses, meet debt service requirements, as well as to pay cash dividends. The payment of dividends by the insurance subsidiaries is subject to varying degrees of supervision by the insurance regulatory authorities in South Dakota and Texas. In South Dakota, where Western Surety and Surety Bonding are domiciled, insurance companies may only pay dividends from earned surplus excluding surplus arising from unrealized capital gains or revaluation of assets. In Texas, where USA is domiciled, an

27

insurance company may only declare or pay dividends to stockholders from the insurer's earned surplus. 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 appropriate insurance department 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 2005 is based on statutory surplus and income at and for the year ended December 31, 2004. Without prior regulatory approval, CNA Surety's insurance subsidiaries may pay stockholder dividends of \$46.8 million in the aggregate in 2005. CNA Surety received dividends of \$10 million from its insurance subsidiaries during the first nine months of 2005 and no dividends from its insurance subsidiaries during the first nine months of 2004. CNA Surety received \$1.5 million in dividends from its non-insurance subsidiaries during the first nine months of 2005, including \$0.5 million in cash. CNA Surety received no dividends from its non-insurance subsidiaries during the first nine months of 2004.

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Combined statutory surplus totaled \$261.9 million at September 30, 2005, resulting in a net written premium to statutory surplus ratio of 1.4 to 1. Insurance regulations restrict Western Surety's maximum net retention on a single surety bond to 10 percent of statutory surplus. Under the 2005 Excess of Loss Treaty, the Company's net retention on new bonds would generally be \$10 million plus a 5% co-participation in the \$90 million layer of excess reinsurance above the Company's retention and this regulation would require minimum statutory surplus of \$145.0 million at Western Surety. This surplus constraint 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 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 (or refunds received from) the Internal Revenue Service ("IRS"). CNA Surety received \$11.8 million from its subsidiaries for the nine months ended September 30, 2005. CNA Surety distributed tax payments of \$12.5 million to its subsidiaries for the nine months ended September 30, 2004.

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 are based on an insurer's statutory surplus. Effective July 1, 2004 through June 30, 2005, the underwriting limitations of Western Surety and Surety Bonding were \$18.5 million and \$0.6 million, respectively. Effective July 1, 2005 through June 30, 2006, the underwriting limitations of Western Surety and Surety Bonding are \$24.6 million and \$0.7 million, respectively. Through the Surety Quota Share Treaty between CCC and Western Surety Company, CNA Surety has access to CCC and its affiliates' U.S. Department of Treasury underwriting limitations. The Surety Quota Share Treaty had an original term of five years from the Merger Date and was renewed on October 1, 2002, January 1, 2004 and January 1, 2005 on substantially the same terms. Effective July 1, 2004 through June 30, 2005, the underwriting limitations of CCC and its affiliates totaled \$591.1 million. Effective July 1, 2005 through June 30, 2006, the underwriting limitations of CCC and its affiliates total \$645.7 million. CNA Surety management believes that the foregoing U.S. Treasury underwriting limitations are sufficient for the conduct of its business.

Subject to the aforementioned uncertainties concerning the Company's per principal net retentions, 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.

28

FINANCIAL CONDITION

INVESTMENT PORTFOLIO

The estimated fair value and amortized cost or cost of fixed income and equity securities held by CNA Surety at September 30, 2005 and December 31, 2004, by investment category, were as follows (dollars in thousands):

GROSS
UNREALIZED LOSSES

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SEPTEMBER 30, 2005	AMORTIZED COST OR COST	GROSS UNREALIZED GAINS	LESS THAN 12 MONTHS	MORE THAN 12 MONTHS
-----	-----	-----	-----	-----
Fixed income securities:				
U.S. Treasury securities and obligations of U.S.				
Government and agencies:				
U.S. Treasury.....	\$ 15,650	\$ 38	\$ (131)	\$ (10)
U.S. Agencies.....	14,120	26	(125)	(61)
Collateralized mortgage obligations.....	18,661	449	(99)	--
Mortgage pass-through securities.....	48,736	110	(430)	(352)
Obligations of states and political subdivisions...	465,506	16,461	(1,176)	(358)
Corporate bonds.....	75,602	2,244	(656)	(18)
Non-agency collateralized mortgage obligations.....	22,203	--	(459)	--
Other asset-backed securities:				
Second mortgages/home equity loans.....	25,924	133	(122)	--
Other.....	6,748	167	(70)	--
Redeemable preferred stock.....	3,000	188	--	--
	-----	-----	-----	-----
Total fixed income securities.....	696,150	19,816	(3,268)	(799)
Equity securities.....	1,144	105	--	--
	-----	-----	-----	-----
Total.....	\$697,294	\$19,921	\$ (3,268)	\$ (799)
	=====	=====	=====	=====

DECEMBER 31, 2004	AMORTIZED COST OR COST	GROSS UNREALIZED GAINS	LESS THAN 12 MONTHS	MORE THAN 12 MONTHS
-----	-----	-----	-----	-----
Fixed income securities:				
U.S. Treasury securities and obligations of U.S.				
Government and agencies:				
U.S. Treasury.....	\$ 55,818	\$ 255	\$ (39)	\$ --
U.S. Agencies.....	4,576	39	(9)	(49)
Collateralized mortgage obligations.....	18,260	590	(105)	--
Mortgage pass-through securities.....	56,696	325	(249)	--
Obligations of states and political subdivisions...	431,624	23,467	(387)	(87)
Corporate bonds.....	94,363	4,735	(27)	(2)
Non-agency collateralized mortgage obligations.....	2,078	3	--	--
Other asset-backed securities:				
Second mortgages/home equity loans.....	20,942	241	(69)	--
Credit card receivables.....	867	--	--	--
Other.....	7,794	391	--	--
Redeemable preferred stock.....	5,356	941	--	--
	-----	-----	-----	-----
Total fixed income securities.....	698,374	30,987	(885)	(138)
Equity securities.....	1,084	114	--	--
	-----	-----	-----	-----
Total.....	\$699,458	\$31,101	\$ (885)	\$ (138)
	=====	=====	=====	=====

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29

The following table summarizes for fixed income securities in an unrealized loss position at September 30, 2005 and 2004, 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, 2005		DECEMBER 31, 2004	
		GROSS		GROSS
UNREALIZED LOSS AGING	ESTIMATED	UNREALIZED	ESTIMATED	UNREALIZED
	FAIR VALUE	LOSS	FAIR VALUE	LOSS
Fixed income securities:				
0-12 months.....	\$238,276	\$3,268	\$107,401	\$ 885
Greater than 12 months.....	24,450	799	5,484	138
Total fixed income securities...	\$262,726	\$4,067	\$112,885	\$1,023

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 impairing 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 impairment loss incorporates both quantitative criteria and qualitative information. 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, (d) whether the debtor is current on interest and principal payments and (e) general market conditions and industry or sector specific factors.

For securities for which an impairment loss has been recorded, the security is written down to fair value and the resulting losses are recognized in realized gains/losses in the Condensed Consolidated Statements of Operations.

As of September 30, 2005, 70 separate securities held by the Company were in an unrealized loss position. Of these, 46 securities were rated "AAA" by Standard and Poor's ("S&P") and "Aaa" by Moody's Investor Services ("Moody's"). One security was rated below investment grade by Moody's and investment grade by

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S&P. Only two securities were in loss positions that exceeded 5% of their respective book values, with the largest unrealized loss being approximately 6% of that security's book value. The Company believes that virtually all of the unrealized losses have resulted from changes in interest rates. No other-than-temporary impairments were recorded for the nine months ended September 30, 2005. No other-than-temporary impairments were recorded for the year ended December 31, 2004.

IMPACT OF PENDING ACCOUNTING STANDARDS

In December of 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (revised 2004), "Share-Based Payments" ("SFAS 123R"), that amends SFAS No. 123 ("SFAS 123"), as originally issued in May of 1995. SFAS 123R addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. SFAS 123R supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"). After the effective date of this standard, entities will not be permitted to use the intrinsic value method specified in APB No. 25 to measure compensation expense and generally would be required to measure compensation expense using a fair-value based method. Public companies are to apply this standard using either the modified prospective method or the modified retrospective method. The modified prospective method requires a company to (a) record compensation expense for all awards it grants after the date it adopts the standard and (b) record compensation expense for the unvested portion of previously granted awards that remain outstanding at the date of adoption. The modified retrospective method requires companies to record compensation expense to either (a) all prior years for which SFAS 123 was effective (i.e. for all fiscal years beginning after December 15, 2004) or (b) only to prior interim periods in the year of initial adoption if the effective date of SFAS 123R does not coincide with the beginning of the fiscal year. SFAS 123R is effective for annual periods beginning after June 15, 2005. The SEC issued Staff Accounting Bulletin

30

("SAB") No. 107 that provides implementation guidance on the adoption of SFAS 123R. Adoption of this standard is not expected to have a material impact on the Company's results of operations and/or equity.

In May of 2005, the FASB issued Statement of Financial Accounting Standard No. 154, Accounting Changes and Error Correction. This standard is a replacement of Accounting Policy Board Opinion No. 20 and FASB Standard No. 3. Under the new standard, any voluntary changes in accounting principles should be adopted via a retrospective application of the accounting principle in the financial statements presented in addition to obtaining an opinion from the auditors that the new principle is preferred. In addition, adoption of a change in accounting principle required by the issuance of a new accounting standard would also require retroactive restatement, unless the new standard includes explicit transition guidelines. This new standard is effective for fiscal years beginning after December 14, 2005.

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

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expressions. Forward-looking statements in this report 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;

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- results of financing efforts, including the availability of bank credit facilities;
- 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 further 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.

The tables below summarize the estimated effects of certain hypothetical increases and decreases in interest rates. It is assumed that the changes occur immediately and uniformly across each investment category. The hypothetical changes in market interest rates selected reflect the Company's expectations of the reasonably possible best or worst case scenarios over a one-year period. The hypothetical fair values are based upon the same prepayment assumptions that were utilized in computing fair values as of September 30, 2005. 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, 2005	HYPOTHETICAL CHANGE IN INTEREST RATE (BP=BASIS POINTS)	ESTIMATED VALUE
		HYPOTHETICAL CHANGE IN INTEREST RATE

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			(DOLLARS IN THOUSAND)
U.S. Government and government agencies and authorities.....	\$ 96,582	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease	\$ 87 92 99 102
States, municipalities and political subdivisions..	480,433	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease	425 452 509 541
Corporate bonds and all other.....	134,884 -----	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease	122 128 141 148
Total fixed income securities.....	\$711,899 =====	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease	635 673 750 791

32

	FAIR VALUE AT SEPTEMBER 30, 2005	HYPOTHETICAL CHANGE IN INTEREST RATE (BP=BASIS POINTS)	ESTIMATED VALUE HYPOTHETICAL CHANGE IN INTEREST RATE
			(DOLLARS IN THOUSAND)
U.S. Government and government agencies and authorities.....	\$136,108	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease	\$123 130 141 145
States, municipalities and political subdivisions..	454,617	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease	398 426 484 515
Corporate bonds and all other.....	137,613 -----	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease	122 128 141 148
Total fixed income securities.....	\$728,338 =====	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease	644 684 766 810

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

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under the Securities and Exchange Act of 1934, 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 7 of the Condensed Consolidated Financial Statements included under Part 1, Item 1.

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

ITEM 3. DEFAULTS UPON SENIOR SECURITIES - None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS - None.

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

July 28, 2005; CNA Surety Corporation Press Release issued on July 28, 2005 (Credit Facility Restructure)

33

ITEM 6. EXHIBITS

	EXHIBIT NUMBER -----
Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	31.1
Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	31.2
Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	32.1 *
Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	32.2 *

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- * 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.

34

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 31, 2005

35

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. |
| 32(1) | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002- Chief Executive Officer. |
| 32(2) | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002- Chief Financial Officer. |

36