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CNA SURETY CORP
Form 10-Q
October 31, 2006

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FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from _____ to _____

Commission file number: 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.)

333 S. WABASH AVE., CHICAGO, ILLINOIS
(Address of principal executive offices)

60604
(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 ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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

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

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

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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:

43,750,467 shares of Common Stock, \$.01 par value as of October 20, 2006.

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CNA SURETY CORPORATION AND SUBSIDIARIES

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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 (the "Corporation") as of September 30, 2006, and the related condensed consolidated statements of income for the three-month and nine-month periods ended September 30, 2006 and 2005, and the related condensed consolidated statements of stockholders' equity and of cash flows for the nine-month periods ended September 30, 2006 and 2005. These interim financial statements are the responsibility of the Corporation's management.

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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 the 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.

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, 2005, 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 24, 2006, 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, 2005 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, 2006

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

ASSETS

Invested assets and cash:

Fixed income securities, at fair value (amortized cost: \$775,891 and \$710,775).....	
Equity securities, at fair value (cost: \$1,447 and \$1,201).....	
Short-term investments, at cost (approximates fair value).....	
Other investments, at cost (approximates fair value).....	

Total invested assets.....	
----------------------------	--

Cash.....	
-----------	--

Deferred policy acquisition costs.....	
----------------------------------------	--

Insurance receivables:

Premiums, including \$11,415 and \$7,947 from affiliates, (net of allowance for doubtful accounts \$1,427 and \$1,490).....	
-----------------------------------------------------------------------------------------------------------------------------	--

Reinsurance, including \$55,428 and \$53,025 from affiliates.....	
-------------------------------------------------------------------	--

Deposit with affiliated ceding company.....	
---------------------------------------------	--

Intangible assets (net of accumulated amortization: \$25,523 and \$25,523).....	
---------------------------------------------------------------------------------	--

Property and equipment, at cost (less accumulated depreciation and amortization: \$23,400 and \$24,887).....	
--------------------------------------------------------------------------------------------------------------	--

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Prepaid reinsurance premiums.....
Accrued investment income.....
Other assets.....

Total assets.....

LIABILITIES

Reserves:

Unpaid losses and loss adjustment expenses.....
Unearned premiums.....

Total reserves.....

Debt.....

Deferred income taxes, net.....

Current income taxes payable.....

Reinsurance and other payables to affiliates.....

Accrued expenses.....

Other liabilities.....

Total liabilities.....

Commitments and contingencies (See Notes 4, 5, 6 & 7)

STOCKHOLDERS' EQUITY

Common stock, par value \$.01 per share, 100,000 shares authorized; 45,136 shares issued and 43,744 shares outstanding at September 30, 2006 and 44,734 shares issued and 43,334 shares outstanding at December 31, 2005.....

Additional paid-in capital.....

Retained earnings.....

Accumulated other comprehensive income.....

Treasury stock, at cost.....

Total stockholders' equity.....

Total liabilities and stockholders' equity.....

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

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

	THREE MONTHS END SEPTEMBER 30,	
	2006	2005
Revenues:		
Net earned premium.....	\$ 102,798	\$ 102,798
Net investment income.....	9,850	9,850
Net realized investment gains (losses).....	(999)	(999)

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Total revenues.....	111,649	
Expenses:		
Net losses and loss adjustment expenses.....	21,133	
Net commissions, brokerage and other underwriting expenses.....	56,527	
Interest expense.....	967	
Total expenses.....	78,627	
Income before income taxes.....	33,022	
Income tax expense.....	9,402	
Net income.....	\$ 23,620	\$
Earnings per common share.....	\$ 0.54	\$
Earnings per common share, assuming dilution.....	\$ 0.54	\$
Weighted average shares outstanding.....	43,558	
Weighted average shares outstanding, assuming dilution.....	43,897	

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

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

	COMMON STOCK SHARES OUTSTANDING	COMMON STOCK
Balance, December 31, 2004.....	43,015	\$ 44
Comprehensive income:		
Net income.....	--	--
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).....	--	--
Total comprehensive income.....		
Stock options exercised and other.....	244	
Balance, September 30, 2005.....	43,259	\$ 44
Balance, December 31, 2005.....	43,334	\$ 44
Comprehensive income:		
Net income.....	--	--
Other comprehensive income:		
Change in unrealized gains on securities, after income tax expense		

of \$166 (net of reclassification adjustment of \$892, after income tax expense of \$480).....

Stock options exercised and other.....

\$ 45

\$ 19

(9)

\$ 10

—

\$ 7

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CASH FLOWS FROM OPERATING ACTIVITIES:

Net income.....	\$
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization.....	
Amortization of bond premium, net.....	
Loss on disposal of property and equipment.....	
Net realized investment (gains) losses.....	
Stock-based compensation.....	
Changes in:	
Insurance receivables.....	
Reserve for unearned premiums.....	
Reserve for unpaid losses and loss adjustment expenses.....	
Deposits with affiliated ceding company.....	
Deferred policy acquisition costs.....	
Deferred income taxes, net.....	
Reinsurance and other payables to affiliates.....	
Prepaid reinsurance premiums.....	
Accrued expenses.....	
Other assets and liabilities.....	
Net cash provided by operating activities.....	

CASH FLOWS FROM INVESTING ACTIVITIES:

Fixed income securities:	
Purchases.....	
Maturities.....	
Sales.....	
Purchases of equity securities.....	
Proceeds from the sale of equity securities.....	
Changes in short-term investments.....	
Purchases of property and equipment, net.....	
Changes in receivables/payables for securities sold/purchased.....	
Other, net.....	
Net cash used in investing activities.....	

CASH FLOWS FROM FINANCING ACTIVITIES:

Principal payments on debt.....	
Debt issuance costs.....	
Employee stock option exercises and other.....	

Net cash used in financing activities.....	
Increase (decrease) in cash.....	
Cash at beginning of period.....	
Cash at end of period.....	\$

Supplemental Disclosure of Cash Flow Information:

Cash paid during the period for:	
Interest.....	\$
Income taxes.....	

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

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CNA SURETY CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2006 (UNAUDITED)

1. SIGNIFICANT ACCOUNTING POLICIES

FORMATION OF CNA SURETY CORPORATION AND MERGER

In December 1996, CNA Financial Corporation ("CNAF") and Capsure Holdings Corp. ("Capsure") agreed to merge (the "Merger") the surety business of CNAF with Capsure's insurance subsidiaries, Western Surety Company ("Western Surety"), Surety Bonding Company of America ("Surety Bonding") and Universal Surety of America ("USA"), into CNA Surety Corporation ("CNA Surety" or the "Company"). CNAF, through its operating subsidiaries, writes multiple lines of property and casualty insurance, including surety business that is reinsured by Western Surety. CNAF owns approximately 63% of the outstanding common stock of CNA Surety. Loews Corporation ("Loews") owns approximately 89% 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.

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 2005 Form 10-K. Certain financial information that is included in annual financial statements prepared in accordance with GAAP is not required for interim reporting and has been condensed or omitted. The accompanying unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all adjustments necessary for a fair presentation of the interim financial statements. All such adjustments are of a normal and recurring nature. The financial results for interim periods may not be indicative of financial results for a full year. Certain reclassifications have been made to the 2005 financial statements to conform with the presentation in the 2006 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.

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

	THREE MONTHS ENDED SEPTEMBER 30,	
	2006	2005
	-----	-----
Net income.....	\$ 23,620	\$ 19,783
	=====	=====
Shares:		
Weighted average shares outstanding.....	43,519	43,140
Weighted average shares of options exercised and additional stock issuance.....	39	28
	-----	-----
Total weighted average shares outstanding.....	43,558	43,168
Effect of dilutive options.....	339	217
	-----	-----
Total weighted average shares outstanding, assuming dilution.....	43,897	43,385
	=====	=====
Earnings per share.....	\$ 0.54	\$ 0.46
	=====	=====
Earnings per share, assuming dilution.....	\$ 0.54	\$ 0.46
	=====	=====

No adjustments were made to reported net income in the computation of earnings per share. There were no options excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2006. Options to purchase shares of common stock of 0.4 million were excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2005 because the exercise price of these options was greater than the average market price of CNA Surety's common stock.

As discussed below, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-based Payment" ("SFAS 123R") on January 1, 2006. Prior to 2006, the Company applied the intrinsic value method under Accounting Principles Board ("APB") Opinion No. 25 ("APB 25"), and related interpretations, in accounting for its stock-based compensation plan as allowed under the provisions of SFAS No. 123, "Accounting for Stock-based Compensation" ("SFAS 123"). Under the recognition and measurement principles of APB 25, no stock-based compensation cost was recognized, as the exercise price of the granted options equaled the market price of the underlying stock 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 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,

Net income.....	\$
Less: Total stock-based compensation cost determined under the fair value method,	

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net of tax.....	
Pro forma net income.....	\$
Basic and diluted earnings per share, as reported.....	\$
Basic earnings per share, pro forma.....	\$
Diluted earnings per share, pro forma.....	\$

ACCOUNTING PRONOUNCEMENTS

In December of 2004, the Financial Accounting Standards Board ("FASB") issued SFAS 123R, that amends 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 25. Under SFAS 123R, 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 SFAS 123R 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 SFAS 123R 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 was effective for the Company on January 1, 2006. The Company applied the modified prospective transition method. The Company accounted for graded vesting using the accelerated method. The Company applied the alternative transition method in calculating its pool of excess tax benefits available to absorb future tax deficiencies as provided by FSP FAS 123(R)-3, "Transition Election Related to Accounting for

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the Tax Effects of Share-Based Payment Awards". Adoption of SFAS 123R decreased net income by \$0.2 million and \$0.6 million for the three and nine months ended September 30, 2006.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Correction". This standard is a replacement of APB 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 standard was effective for fiscal years beginning after December 15, 2005, and was adopted by the Company as of January 1, 2006. Adoption of this standard did not have an impact on the Company's results of operations and/or equity.

In November of 2005, the FASB issued FASB Staff Position ("FSP") No. 115-1

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and No. 124-1, "The Meaning of Other-than-Temporary Impairment and its Application to Certain Investments" ("FSP 115-1 and 124-1"), as applicable to debt and equity securities that are within the scope of SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS 115") and equity securities that are accounted for using the cost method specified in APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock". FSP 115-1 and 124-1 nullified certain requirements of Emerging Issues Task Force Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments" ("EITF 03-1"), which was originally issued in March 2004 and was effective for reporting periods beginning after June 15, 2004. FSP 115-1 and 124-1 replaces guidance set forth in EITF 03-1 with references to existing other-than-temporary impairment guidance and clarifies that an investor should recognize an impairment loss no later than when the impairment is deemed other than temporary, even if a decision to sell has not been made. FSP 115-1 and 124-1 carries forward the requirements in EITF 03-1 regarding required disclosures in the financial statements and requires additional disclosure related to factors considered in reaching the conclusion that the impairment is other-than-temporary. In addition, in periods subsequent to the recognition of an other-than-temporary impairment loss for debt securities, FSP 115-1 and 124-1 allows for amortization of the discount or reduced premium over the remaining life of the security based on future estimated cash flows. FSP 115-1 and 124-1 was effective for fiscal years beginning after December 15, 2005 and was adopted by the Company on January 1, 2006. Adoption of FSP 115-1 and 124-1 did not have a material impact on the Company's results of operations and/or equity.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (an amendment of FASB Statements No. 87, 88, 106 and 132(R) ("SFAS 158"). SFAS 158 requires a company who sponsors one or more single-employer defined benefit plans to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS 158 requires a company to measure benefit plan assets and obligations as of the date of the company's fiscal year-end statement of financial position. SFAS 158 also requires a company to disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The Company is currently evaluating the impact that adopting SFAS 158 will have on our financial condition.

2. INVESTMENTS

The estimated fair value and amortized cost or cost of fixed income and equity securities held by CNA Surety at September 30, 2006 and December 31, 2005, by investment category, were as follows (dollars in thousands):

	AMORTIZED COST OR COST	GROSS UNREALIZED GAINS	GROSS U LESS THAN MONTHS
	-----	-----	-----

SEPTEMBER 30, 2006

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Fixed income securities:

U.S. Treasury securities and obligations of U.S.

Government and agencies:

U.S. Treasury.....	\$ 14,846	\$ --	\$ (1
U.S. Agencies.....	40,030	60	
Collateralized mortgage obligations.....	17,246	345	
Mortgage pass-through securities.....	40,446	76	
Obligations of states and political subdivisions.....	515,553	13,982	
Corporate bonds.....	66,936	1,465	(1
Non-agency collateralized mortgage obligations.....	37,068	242	
Other asset-backed securities:			
Second mortgages/home equity loans.....	20,925	--	(
Credit card receivables.....	17,228	252	
Other.....	5,613	70	
	-----	-----	-----
Total fixed income securities.....	775,891	16,492	(3
Equity securities.....	1,447	125	
	-----	-----	-----
Total.....	\$ 777,338	\$ 16,617	\$ (3
	=====	=====	=====

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	AMORTIZED COST OR COST	GROSS UNREALIZED GAINS	GROSS U LESS THAN MONTHS
	-----	-----	-----
DECEMBER 31, 2005			
Fixed income securities:			
U.S. Treasury securities and obligations of U.S.			
Government and agencies:			
U.S. Treasury.....	\$ 15,637	\$ --	\$ (32
U.S. Agencies.....	40,055	131	(195
Collateralized mortgage obligations.....	18,696	432	(223
Mortgage pass-through securities.....	45,607	87	(647
Obligations of states and political subdivisions.....	464,417	14,424	(1,282
Corporate bonds.....	69,626	1,885	(1,152
Non-agency collateralized mortgage obligations.....	22,200	--	(690
Other asset-backed securities:			
Second mortgages/home equity loans.....	25,924	21	(181
Other.....	5,613	93	(115
Redeemable preferred stock.....	3,000	128	--
	-----	-----	-----
Total fixed income securities.....	710,775	17,201	(4,517
Equity securities.....	1,201	105	--
	-----	-----	-----
Total.....	\$ 711,976	\$ 17,306	\$ (4,517
	=====	=====	=====

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 over the life of the security, 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

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impairment losses, if any.

During the third quarter of 2006, the Company recognized impairment losses on 21 municipal fixed income securities that were in an unrealized loss position. In response to the significant change in interest rates in the third quarter, as well as a revised outlook on future interest rates, the Company does not have the intention of holding these securities to their anticipated recovery. The other-than-temporary impairment losses on these securities were \$0.9 million.

As of September 30, 2006, 65 securities held by the Company were in an unrealized loss position. The Company believes that 64 of these securities are in an unrealized loss position because of changes in interest rates and therefore expects these securities will recover in value at or before maturity. Of these 65 securities, 44 were rated "AAA" by Standard & Poor's ("S&P") and "Aaa" by Moody's Investor Services ("Moody's") and all were investment grade. Two of these 65 securities were in a loss position that exceeded 5% of its book value, with the largest percentage unrealized loss being approximately 6.8% of that security's book value resulting in an unrealized loss of \$0.1 million. The largest unrealized loss was \$0.4 million, which was approximately 4.7% of that security's book value.

The remaining security that was in an unrealized loss position was issued by the financing subsidiary of a large domestic automaker. The security was in an unrealized loss position of approximately 4.9% (\$0.2 million) of its book value and was rated below investment grade by S&P and Moody's. The Company believes that the financial condition and near-term prospects of the issuer are strong, and expects that the unrealized loss will reverse. The Company intends and believes it has the ability to hold this investment until the expected recovery in value, which may be at maturity.

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

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3. REINSURANCE

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

			THREE
			2006
			WRITTEN
Direct.....	\$	85,663	\$
Assumed.....		30,241	
Ceded.....		(10,837)	
	\$	105,067	\$
		=====	=====

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		NINE M	
		2006	
	WRITTEN		
Direct.....	\$ 259,015	\$	
Assumed.....	88,932		
Ceded.....	(31,777)		
	\$ 316,170	\$	
	=====		

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):

		TH	
Gross losses and loss adjustment expenses.....	\$ 9,		
Ceded amounts.....	11,		
Net losses and loss adjustment expenses.....	\$ 21,		
	=====		

Gross losses and loss adjustment expenses.....	\$ 65		
Ceded amounts.....	4		
Net losses and loss adjustment expenses.....	\$ 69		
	=====		

During the three months ended September 30, 2006 and 2005, the Company recorded results based on independent actuarial reviews performed during the respective quarters which indicated that gross reserves should be reduced by approximately \$17.0 million and \$15.0 million, respectively. This adjustment reflects changes in estimates of incurred-but-not-reported reserves. The

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corresponding change in ceded reserves was such that net reserves were reduced by \$5.1 million and \$3.4 million for the three months ended September 30, 2006 and 2005, respectively. These actions resulted in the unusual relationships in the gross and ceded amounts shown above.

2006 THIRD PARTY REINSURANCE COMPARED TO 2005 THIRD PARTY REINSURANCE

Effective January 1, 2006, CNA Surety entered into a new excess of loss treaty ("2006 Excess of Loss Treaty") with a group of third party reinsurers on terms similar to the 2005 Excess of Loss Treaty. Under the 2006 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 primary difference between the 2006 Excess of Loss Treaty and the Company's 2005 Excess of Loss Treaty is as follows. The base annual premium for the 2006 Excess of Loss Treaty is \$36.9 million compared to the actual cost of the 2005 Excess of Loss Treaty of \$41.5 million. The contract includes an optional extended discovery period, for an additional premium (a percentage of the original premium based on any unexhausted aggregate limit by layer), which will provide coverage for losses discovered beyond 2006 on bonds that were in force during 2006.

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.

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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, 2006 and expires on December 31, 2006 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 September 30, 1997 (the "Merger Date"). The Quota Share Treaty was renewed on January 1, 2006 and expires on December 31, 2006 and is annually renewable thereafter. CCC and CIC transfer the related liabilities of such business and pay to Western Surety an amount in cash equal to CCC's and CIC's net written premiums written on all such business, minus a quarterly ceding commission to be retained by CCC and CIC equal to \$50,000 plus 25% of net written premiums written on all such business. This contemplates an approximate 4% override commission for fronting fees to CCC and CIC on their actual direct acquisition costs.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of the Merger Date by agreeing to pay Western Surety, within 30 days following the end of each calendar quarter, the amount of any adverse development on such reserves, as re-estimated as of the end of such calendar quarter. There was no adverse reserve development for the period from the Merger Date through September 30, 2006.

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

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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, 2006 and December 31, 2005, the Company had billed and received \$45.9 million under the Stop Loss Contract. As of September 30, 2006, the Company had an estimated unpaid loss recoverable balance of approximately \$2.0 million under the Stop Loss Contract.

The Company and CCC previously participated in a \$40 million excess of \$60 million reinsurance contract effective from January 1, 2005 to December 31, 2005 providing coverage exclusively for the one large national contractor 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. 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 was from January 1, 2005 to December 31, 2005. In November 2005, the Company and CCC agreed by addendum to extend this contract for twelve months. This extension, expiring December 31, 2006, was for an additional minimum premium of \$0.8 million, subject to adjustment based on the level of actual premiums written on bonds for the large national contractor. As of September 30, 2006 and December 31, 2005, the Company has ceded losses of \$50.0 million under the terms of this contract.

The Company and CCC entered into a \$50 million excess of \$100 million contract for the period of January 1, 2005 to December 31, 2005. The premium for this contract was \$4.8 million plus an additional premium of \$14.0 million if a loss was 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 December 31, 2005, no losses were ceded under this contract, which was not renewed for 2006.

As of September 30, 2006 and December 31, 2005, CNA Surety had an insurance receivable balance from CCC and CIC of \$66.8 million and \$61.0 million, respectively. CNA Surety had no reinsurance payables to CCC and CIC as of September 30, 2006 and December 31, 2005.

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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,		NIN
2006	2005	20

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Reserves at beginning of period:			
Gross.....	\$ 435,725	\$ 402,769	\$ 42
Ceded reinsurance.....	155,237	114,212	14
	-----	-----	-----
Net reserves at beginning of period.....	280,488	288,557	27
	-----	-----	-----
Net incurred loss and loss adjustment expenses:			
Provision for insured events of current period.....	26,266	23,403	7
Decrease in provision for insured events of prior periods...	(5,133)	(3,427)	(
	-----	-----	-----
Total net incurred.....	21,133	19,976	6
	-----	-----	-----
Net payments attributable to:			
Current period events.....	2,525	1,444	
Prior period events.....	21,929	3,099	6
	-----	-----	-----
Total net payments.....	24,454	4,543	6
	-----	-----	-----
Net reserves at end of period.....	277,167	303,990	27
Ceded reinsurance at end of period.....	143,070	101,957	14
	-----	-----	-----
Gross reserves at end of period.....	\$ 420,237	\$ 405,947	\$ 42
	=====	=====	=====

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 provided an aggregate of up to \$50.0 million in borrowings under a revolving credit facility. In the third quarter of 2006, the outstanding 2005 Credit Facility balance of \$20.0 million was paid. Also, in September 2006, the Company reduced the available aggregate revolving credit facility to \$25.0 million in borrowings. 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%. There was no outstanding balance under the 2005 Credit Facility at September 30, 2006. As such, there was no applicable margin and the weighted average interest rate was 0.325% at September 30, 2006.

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 Company, Inc. ("A.M. Best") 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 as of and for the period ended September 30, 2006.

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 Company's investment of \$0.9 million in the Issuer Trust is carried at cost in "Other assets" in the Company's Condensed Consolidated Balance Sheet. The sole asset of the Issuer

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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, 2006 the interest rate on the junior subordinated debenture was 8.78%.

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6. EMPLOYEE BENEFITS

CNA Surety established the CNA Surety Corporation Deferred Compensation Plan (the "2000 Plan"), effective April 1, 2000. The Company established and maintains the 2000 Plan as an unfunded, non-qualified deferred compensation plan for a select group of management or highly compensated employees. The purpose of the 2000 Plan is to permit designated employees of the Company and participating affiliates to accumulate additional retirement income through a non-qualified 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 "2005 Plan") and the CNA Surety Corporation 2005 Deferred Compensation Plan Trust (the "2005 Trust"). The 2005 Plan and 2005 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 2005 Plan and 2005 Trust will be used in lieu of the 2000 Plan and the CNA Surety Corporation Deferred Compensation Plan Trust (the "2000 Trust") for all amounts deferred on or after January 1, 2005. Amounts deferred under the 2000 Plan prior to January 1, 2005 will continue to be covered by and paid out in accordance with the terms of the 2000 Plan, the 2000 Trust and the elections made by participants under the 2000 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
	2006	2005	2006
Net periodic benefit cost:			
Service cost.....	\$ 46	\$ 107	\$ 194
Interest cost.....	152	233	438

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Prior service cost.....	(41)	(40)	(121)
Recognized net actuarial loss.....	78	145	203
	-----	-----	-----
Net periodic benefit cost.....	\$ 235	\$ 445	\$ 714
	=====	=====	=====

The Company expects to contribute \$0.2 million to the postretirement benefit plans to pay benefits in 2006. As of September 30, 2006, \$0.2 million of contributions have been made to the postretirement benefit plans.

7. COMMITMENTS AND CONTINGENCIES

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

8. STOCK-BASED COMPENSATION

The compensation expense recorded for the Company's stock-based compensation plan was \$0.3 million and \$1.0 million for the three and nine months ended September 30, 2006. The total income tax benefit recognized in the income statement for stock-based compensation arrangements was \$0.1 million and \$0.3 million for the three and nine months ended September 30, 2006. The amount of cash received from the exercise of stock options was \$1.0 million and \$0.4 million for the three months ended September 30, 2006 and September 30, 2005, respectively, and \$5.8 million and \$2.8 million for the nine months ended September 30, 2006 and September 30, 2005, respectively.

EQUITY COMPENSATION PLANS

The Company previously reserved shares of its common stock for issuance to directors, officers, employees and certain advisors of the Company through incentive stock options, non-qualified stock options and stock appreciation rights ("SARs") to be granted under the CNA Surety 1997 Long-Term Equity Compensation Plan (the "1997 Plan"). No options were granted under the 1997 Plan during the three and nine months ended September 30, 2006.

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The Company's 2006 Long-Term Equity Compensation Plan (the "2006 Plan"), approved by shareholders on April 25, 2006, replaced the 1997 Plan. Incentive stock options, non-qualified stock options, restricted stock, bonus shares, or SARs may be granted to directors, officers, employees and certain advisors of the Company under the 2006 Plan. The aggregate number of shares initially available for which options may be granted under the 2006 Plan was 3,000,000.

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

The 2006 Plan provides for the granting of incentive stock options as defined under Section 382 of the Internal Revenue Code of 1986, as amended. All non-qualified stock options and incentive stock options granted under the 2006 Plan expire ten years after the date of grant and vest ratably over the

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four-year period following the date of grant.

No options were granted under the 2006 Plan during the three and nine months ended September 30, 2006. As of September 30, 2006, the number of shares available for granting of options under the 2006 Plan was 3,000,000.

A summary of the status of the Company's outstanding options as of September 30, 2006 and changes during the nine months ended September 30, 2006 is presented below:

	SHARES SUBJECT TO OPTION -----	
Outstanding options at January 1, 2006.....	1,587,909	\$
Options granted.....	--	\$
Options forfeited/expired.....	(50,450)	\$
Options exercised.....	(401,859)	\$

Outstanding options at September 30, 2006.....	1,135,600	\$
	=====	

A summary of the status of the Company's non-vested options as of September 30, 2006 and changes during the nine months ended September 30, 2006 is presented below:

	SHARES SUBJECT TO OPTION -----	
Non-vested options at January 1, 2006.....	785,845	\$
Options granted.....	--	
Options vested.....	(14,750)	\$
Options forfeited.....	(29,175)	\$

Non-vested options at September 30, 2006.....	741,920	\$
	=====	

The following table summarizes information about stock options outstanding at September 30, 2006:

	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
	NUMBER	WEIGHTED AVERAGE	WEIGHTED AVERAGE	NUMBER	WEIGHTED AVERAGE
RANGE OF EXERCISE PRICES	OUTSTANDING	REMAINING CONTRACTUAL LIFE	EXERCISE PRICE	EXERCISABLE	EXERCISE PRICE
-----	-----	-----	-----	-----	-----
\$9.35 to \$11.50.....	357,000	6.1 years	\$ 9.86	190,075	\$

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\$12.06 to \$15.875.....	778,600	7.5 years	\$	13.12	203,005	\$
--------------------------	---------	-----------	----	-------	---------	----

The aggregate intrinsic value of options outstanding and options exercisable at September 30, 2006 were \$9.2 million and \$3.1 million, respectively. The total intrinsic value of options exercised during the three and nine months ended September 30, 2006 was \$0.3 million and \$1.6 million, respectively.

As of September 30, 2006, there was \$1.0 million of total unrecognized compensation cost related to non-vested stock-based compensation arrangements granted under the Company's equity compensation plans. That cost is expected to be recognized as follows: remainder of 2006 - \$0.2 million; 2007 - \$0.5 million; 2008 - \$0.2 million; and 2009 - \$0.1 million.

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CNA SURETY CORPORATION AND SUBSIDIARIES

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

GENERAL

The following is a discussion and analysis of CNA Surety Corporation and its subsidiaries' (collectively, "CNA Surety" or the "Company") operating results, liquidity and capital resources, and financial condition. This discussion should be read in conjunction with the Condensed Consolidated Financial Statements in Item 1 of Part 1 of this Quarterly Report on Form 10-Q and the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

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, goodwill and other intangible assets, recognition of premium revenue and the related unearned premium liability, 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. Given the nature of the surety business, the determination of these balances is inherently a highly subjective exercise, which requires management to analyze, weigh, and balance numerous macroeconomic, customer specific, and claim specific factors and trends, most of which, in themselves, are inherently uncertain and difficult to predict.

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 IBNR reserves include provisions for losses in excess of the current case reserve for previously reported claims and for claims that may be reopened. The IBNR reserves also include offsets for anticipated salvage and subrogation recoveries. The following table shows the estimated liability as of September 30, 2006 for unpaid claims applicable to reported claims and to IBNR for each sub-line of business (dollars in thousands):

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	GROSS CASE LOSS AND LAE RESERVES	GROSS IBNR LOSS AND LAE RESERVES	TOTAL GROSS RESERVES
	-----	-----	-----
Contract.....	\$ 120,781	\$ 130,899	\$ 251,680
Commercial.....	108,532	47,763	156,295
Fidelity and other...	5,156	7,106	12,262
	-----	-----	-----
Total.....	\$ 234,469	\$ 185,768	\$ 420,237
	=====	=====	=====

The Company retains an independent actuarial firm of national standing to perform periodic actuarial analyses of the Company's loss reserves. These analyses typically include a comprehensive review performed in the third quarter based on data as of June 30 and an update of the comprehensive review performed in January based on data as of December 31. In between these analyses, management monitors claim activity against benchmarks prepared by the independent actuarial firm based on expected claim activity and consults with the actuarial firm as necessary.

The independent actuarial firm's analyses are based upon multiple projection methodologies that involve detailed statistical analysis of past claim reporting, settlement activity, and salvage and subrogation activity, as

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well as claim frequency and severity data when sufficient information exists to lend statistical credibility to the analysis. The analysis may be based upon internal loss experience or industry experience. Methodologies may vary depending on the type of claim being estimated. While methodologies may vary, each employs significant judgments and assumptions.

In estimating the unpaid claim liabilities, the independent actuarial firm employed the following projection methodologies:

- Historical development method, sometimes referred to as a link ratio method;
- Bornhuetter-Ferguson method on both a paid and incurred basis;
- Average hindsight outstanding projection method;
- Frequency-severity method; and
- Loss ratio method.

The following provides a summary of these projection methodologies:

Historical Development Method

As a group of claims matures, their collective value changes. This change in value over time is referred to as loss development. The loss development method is a traditional actuarial approach which relies on the historical changes in losses from one evaluation point to another to project the current valuation of losses to ultimate settlement values. Development patterns which have been exhibited by more mature (older) years are used to estimate the expected development of the less mature (more recent) years. The strength of this method is that it is very responsive to emerging loss experience for each accident year. The weakness is that this method can become highly leveraged and volatile for less mature accident years.

Bornhuetter-Ferguson Method

The incurred Bornhuetter-Ferguson ("B-F") method is commonly used to provide a more stable estimate of ultimate losses in situations where loss development is volatile, substantial and/or immature. The method calculates IBNR (or unpaid loss when conducting a paid B-F projection) directly as the product of:

Expected Ultimate Losses multiplied by IBNR (or Unpaid) Percentage.

The IBNR (or unpaid) percentage is derived from the incurred (or paid) loss development patterns. Various approaches can be used to determine the expected ultimate losses (e.g., prior year estimates, pricing assumptions, etc.). To obtain an estimate of expected ultimate losses, the independent actuarial firm utilized an expected loss ratio (ultimate losses divided by earned premium) based on review of prior accident years' loss ratio experience. This estimate was then applied to the more recent accident years' earned premium. The strength of the B-F method is that it is less leveraged than the historical development method and thus does not result in an overreaction to an unusual claim occurrence (or an unusual lack of claims). The weakness of the method is that it is reliant on an initial expectation of ultimate losses.

Average Hindsight Outstanding Method

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This method relies on the older, more mature accident years' ultimate loss estimates to restate what the outstanding losses should have been, with hindsight, by accident year by stage of development. These restated hindsight outstanding losses are then trended to the appropriate cost levels for the accident years being projected and added to the paid to date losses in order to generate indicated ultimate losses for the more recent accident years. The strength of this method is that it is relatively unaffected by changes in a company's case reserving practices. The weaknesses of this method are that it is sensitive to payment pattern shifts and that the average hindsight severities can become highly variable for certain datasets.

Frequency-Severity Method

This method first projects the expected number of claims for each accident year and then multiplies this estimate by the expected average cost of claims for the applicable accident year. The number of claims can be projected using the historical development technique or other methodology. The average cost of claims for the more recent accident years is estimated by observing the estimated average cost of claims for the older more mature accident years and trending those values to appropriate cost levels for the more recent accident years. The strength of this method is that it is not reliant on loss development factors for less mature accident years which can become highly leveraged and volatile. The weakness is that this method is slow to react to an abrupt change in claim severities.

Loss Ratio Method

This method relies on historical projected ultimate loss ratios for the more mature accident years to estimate the more recent, less mature accident years' ultimate losses. Applying a selected loss ratio (by reviewing more mature years) to the more recent years' earned premium results in an indication of the more recent years' ultimate losses. The strength of this method is that it can be used in connection with a company's pricing targets and can be used when the historical data has limited credibility. The weakness of this method is that it is slow to react to the emerging loss experience for a particular accident year.

Each of the projection methodologies employed rely to varying degrees on the basic assumption that the Company's historical claim experience is indicative of the Company's future claim development. The amount of weight given to any individual projection method is based on an assessment of the volatility of the historical data and development patterns, an understanding of the changes in the overall surety industry over time and the resultant potential impact of these changes on the Company's prospective claims development, an understanding of the changes to the Company's processes and procedures within its underwriting, claims handling and data systems functions, among other things. The decision as to how much weight to give to any particular projection methodology is ultimately a matter of experience and professional judgment.

Surety results, especially for contract and certain commercial products like insurance program bonds, workers compensation insurance bonds and reclamation bonds, tend to be impacted by fewer, but more severe, losses. With this type of loss experience, it is more difficult to estimate the required reserves, particularly for the most current accident years which may have few reported claims. Therefore, assumptions related to the frequency and magnitude of severe loss are key in estimating surety loss reserves. The Company experienced a period of unusually high frequency of severe loss in accident years 2002 and 2003. In response to this activity, the independent actuarial firm included higher expectations of severe losses in its analysis for 2004. The Company's claim experience improved dramatically since 2004. As a result, the independent actuarial firm's current analysis places less reliance on the severe loss experience in accident years 2002 and 2003.

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The indicated reserve was developed by reviewing the Company's claims experience by accident year for several individual sub-lines of business. Within each sub-line, the selection of the point estimate was made after consideration of the appropriateness of the various projection methodologies in light of the sub-line's loss characteristics and historical data. In general, for the older, more mature, accident years the historical development method (i.e., link ratio method) was relied upon more heavily. For the more recent years, the indicated reserves were more heavily based on the Bornhuetter-Ferguson and loss ratio methods since these are not as reliant on the Company's large (i.e., leveraged) development factors and thus are believed to represent a more stable set of methods from which to select indicated reserves for the more recent years.

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

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- Current claim activity, including the frequency and severity of current claims;
- Changes in underwriting standards and business mix such as the Company's efforts to reduce exposures to large commercial bonds;
- Changes in the claims handling process; and
- Current economic conditions, especially corporate default rates and the condition of the construction economy.

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

The following table shows the point estimate as determined by the Company's independent actuarial firm at December 31, 2005 and as of their most recent analysis, June 30, 2006, compared to the actual loss reserve established by management, both gross and net of reinsurance (dollars in thousands):

Gross Basis:

Recorded loss reserves at December 31, 2005.....	\$ 424,449
Actuarial point estimate at December 31, 2005.....	428,238

Difference at December 31, 2005.....	\$ (3,789)
	=====
Difference as a % of actuarial point estimate.....	(0.9)%
Recorded loss reserves at June 30, 2006.....	\$ 435,725
Actuarial point estimate at June 30, 2006.....	419,080

Difference at June 30, 2006.....	\$ 16,645
	=====
Difference as a % of actuarial point estimate.....	4.0%
Recorded loss reserves at September 30, 2006.....	\$ 420,237
	=====

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Net Basis:

Recorded loss reserves at December 31, 2005.....	\$ 277,015
Actuarial point estimate at December 31, 2005.....	278,617

Difference at December 31, 2005.....	\$ (1,602)
	=====
Difference as a % of actuarial point estimate.....	(0.6)%
Recorded loss reserves at June 30, 2006.....	\$ 280,488
Actuarial point estimate at June 30, 2006.....	276,110

Difference at June 30, 2006.....	\$ 4,378
	=====
Difference as a % of actuarial point estimate.....	1.6%
Recorded loss reserves at September 30, 2006.....	\$ 277,167
	=====

At December 31, 2005, management's recorded reserves were slightly lower than the point estimates determined by the independent actuarial firm, with the difference being somewhat larger on a gross basis. At December 31, 2005, management believed that improved economic conditions, lower corporate default rates, reduced exposure to large commercial bonds and fewer reported severe claims indicated that a lower provision for severe losses was appropriate. Management believed that the actuarial point estimates included provisions for severe losses that were more heavily influenced by the Company's experience in accident years 2002 and 2003 and did not fully reflect the favorable economic conditions and changes in the Company's exposures. While there still is a significant amount of uncertainty regarding the ultimate cost of claims for accident years 2004 and prior, the independent actuarial firm's analyses performed in 2005 did indicate improvement in those accident years which was consistent with management's position concerning the recorded loss reserves at December 31, 2004.

The conclusion of the independent actuarial firm's analyses conducted during the third quarter with data as of June 30, 2006 resulted in lower point estimates, confirming the positive loss trends noted by management. These positive loss trends include improvement in the 2005 accident year primarily due to fewer reported severe claims. During the third quarter, management recorded favorable development on prior accident years of \$5.1 million on a net basis based on the redundancy indicated by the most recent actuarial analysis and the continuation of positive loss experience in the third quarter.

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

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of reinsurance recoveries may prove uncollectible if the reinsurer is unable to perform under the contract. Reinsurance contracts do not relieve the ceding company of its obligations to indemnify its own policyholders.

Casualty insurance loss reserves are subject to a significant amount of uncertainty. Given the nature of surety losses with its low frequency, high severity characteristics, this is particularly true for surety loss reserves. As a result, the range of reasonable loss reserve estimates may be broader than that associated with traditional property/casualty insurance products. While the loss reserve estimates represent the best professional judgments, arrived at after careful actuarial analysis of the available data, it is important to note

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that variation from the estimates is not only possible but, in fact, probable. The degree of such variation could be significant and in either direction from the estimates and could result in actual losses outside of the estimated reserve range. The sources of this inherent variability are numerous - future economic conditions, court decisions, legislative actions, and individual large claim impacts, for example.

The range of reasonable reserve estimates is not intended to reflect the maximum and/or minimum possible outcomes; but rather reflects a range of reasonable estimates given the uncertainty in estimating unpaid claim liabilities for surety business. Further, there is no generally accepted method to estimating reserve ranges, but rather many concepts are currently being vetted within actuarial literature.

In developing the indicated range of reserve estimates for the Company, the independent actuarial firm utilized the Mack methodology and their point estimate analysis in order to estimate the requisite reserve distribution parameters. The Mack methodology is premised on the idea that the volatility in a company's historical paid loss development is representative of the variability in a company's future payments and thus can be used to estimate the variability within a company's reserve estimate. Given the dispersion of the reserve indications, along with its experience and professional judgment, the independent actuarial firm selected the 50th and 75th percentile as representing a reasonable range of reserve estimates.

At December 31, 2005, the range of reasonable loss reserve estimates, net of reinsurance receivables, calculated by the independent actuarial firm and adopted by management was from \$229 million to \$325 million. The 2006 interim review of loss reserves includes only a point estimate calculation and no update of the reserve range. A new reserve range will be calculated as a part of the December 31, 2006 actuarial review. Ranges of reasonable loss reserve estimates are not calculated for the sub-lines of business. Management believes that the range calculated over total reserves provides the most meaningful information due to the importance of correlation of losses between the sub-lines of business related to the impact of general economic conditions.

The primary factors that would result in the Company's actual losses being closer to either end of the reserve range is the emergence of (or lack thereof) a small number of large claims, as well as the recovery of (or lack thereof) a small number of large salvage/subrogation amounts. In other words, the primary factors that, if they were to occur, would result in the Company's actual payments being at the high end of the indicated range are if the Company experiences an unusually high number of large claims and/or an unusually low number of large salvage and subrogation recoveries. Conversely, if the Company were to experience an unusually low number of large claims and/or an unusually high number of large salvage and subrogation recoveries, the Company's actual payments would tend to be at the low end of the range. These variations in outcomes could be driven by broader issues such as the state of the construction economy or the level of corporate defaults, or by the specific facts and circumstances surrounding individual claims. Again, it is important to note that it is possible that the actual payments could fall outside of the estimated range.

The Company's Condensed Consolidated Balance Sheets includes estimated liabilities for unpaid losses and loss adjustment expenses of \$420.2 million and \$424.4 million and reinsurance receivables related to unpaid losses of \$143.0 million and \$147.4 million at September 30, 2006 and December 31, 2005, respectively. Due to the inherent uncertainties in the process of establishing the liabilities for unpaid losses and loss adjustment expenses, the actual ultimate claims amounts will differ from the currently recorded amounts. This difference could have a material effect on reported earnings and financial condition. Future effects from changes in these estimates will be recorded in

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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

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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 over the life of the security. 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, 2006 and December 31, 2005 includes intangible assets of approximately \$138.8 million. These amounts represent goodwill and identified intangibles arising from the acquisition of Capsure Holdings Corp. ("Capsure").

A significant amount of judgment is required in performing intangible asset impairment tests. Such tests are performed annually on October 1, or more frequently if events or changes indicate that the estimated fair value of an intangible asset might be impaired. Under the relevant standard, 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. The Company uses a valuation technique based on discounted cash flows. If the carrying amount of a reporting unit, including goodwill, exceeds the estimated fair value, then individual assets, including identifiable intangible assets, and liabilities of the reporting unit are estimated at fair value. The excess of the estimated fair

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value of the reporting unit over the estimated fair value of net assets would establish the implied value of intangible assets. The excess of the recorded amount of intangible assets over the implied value of intangible assets is recorded as an impairment loss.

INSURANCE PREMIUMS

Insurance premiums are recognized as revenue ratably over the term of the related policies in proportion to the insurance protection provided. Premium revenues are net of amounts ceded to reinsurers. Unearned premiums represent the portion of premiums written, before ceded reinsurance which is shown as an asset, applicable to the unexpired terms of policies in force determined on a pro rata basis.

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 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

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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

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used by the insurance industry and regulators such as state departments of insurance and the National Association of Insurance Commissioners for financial regulation and as a basis of comparison among companies. The ratios discussed in the Company's MD&A are calculated using GAAP financial results and include the net loss and loss adjustment expense ratio ("loss ratio") as well as the net commissions, brokerage and other underwriting expense ratio ("expense ratio") and combined ratio. The loss ratio is the percentage of net incurred losses and loss adjustment expenses to net earned premiums. The expense ratio is the percentage of net commissions, brokerage and other underwriting expenses, including the amortization of deferred 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, 2006 AND 2005

ANALYSIS OF NET INCOME

Net income for the three months ended September 30, 2006 was \$23.6 million, or \$0.54 per share, compared to \$19.8 million, or \$0.46 per share, for the same period in 2005. The increase in net income reflects higher earned premium, higher investment income, and the impacts of lower loss and expense ratios. The components of net income are discussed in the following sections.

Net income for the nine months ended September 30, 2006 was \$61.1 million, or \$1.40 per share, compared to \$21.9 million, or \$0.51 per share, in 2005. The increase in net income reflects the absence of a \$40.0 million pre-tax (\$26.0 million after-tax) charge in 2005 to establish a reserve for contract surety losses related to the large national contractor described in the Company's previous public filings. Other positive impacts included higher earned premium, higher investment income, and a lower expense ratio.

RESULTS OF INSURANCE OPERATIONS

Underwriting components for the Company for the three and nine months ended September 30, 2006 and 2005 are summarized in the following table (dollars in thousands):

THREE MONTHS ENDED SEPTEMBER 30,		NINE MON SEPTE
2006	2005	2006

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Gross written premiums.....	\$ 115,904	\$ 113,482	\$ 347,947
	=====	=====	=====
Net written premiums.....	\$ 105,067	\$ 103,031	\$ 316,170
	=====	=====	=====
Net earned premiums.....	\$ 102,798	\$ 91,061	\$ 291,727
	=====	=====	=====
Net losses and loss adjustment expenses.....	\$ 21,133	\$ 19,976	\$ 69,674
	=====	=====	=====
Net commissions, brokerage and other expenses...	\$ 56,527	\$ 51,891	\$ 160,954
	=====	=====	=====

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Loss ratio.....	20.6%	21.9%	23.9%
Expense ratio.....	55.0	57.0	55.2
	-----	-----	-----
Combined ratio.....	75.6%	78.9%	79.1%
	=====	=====	=====

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 Continental Casualty Company ("CCC") and The Continental Insurance Company ("CIC"), and their affiliates, after September 30, 1997 (the "Merger Date") that is reinsured by Western Surety Company ("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
-----	-----	-----
2006	2005	2006
-----	-----	-----

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Contract	\$ 74,444	\$ 71,044	\$220,646
Commercial	33,862	33,568	102,734
Fidelity and other.....	7,598	8,870	24,567
	-----	-----	-----
	\$115,904	\$113,482	\$347,947
	=====	=====	=====

For the quarter ended September 30, 2006, gross written premiums increased 2.1 percent to \$115.9 million as compared to the quarter ended September 30, 2005. Gross written premiums for contract surety increased 4.8 percent to \$74.4 million primarily due to increased demand as a result of the strong construction economy and growth in contract size due to cost inflation within the construction industry. Gross written premiums for commercial surety increased 0.9 percent to \$33.9 million due to growth in large commercial products. Small commercial premiums decreased slightly as a decline in production of notary bonds resulting from a loss of a large notary program offset growth in other commercial products. Fidelity and other premiums decreased by 14.3 percent, due to a decline in production of notary errors and omissions policies related to the notary program noted above.

For the nine months ended September 30, 2006, gross written premiums increased 7.6 percent to \$347.9 million as compared to the nine-month period ended September 30, 2005. Gross written premiums for contract surety increased 13.6 percent to \$220.6 million primarily due to increased demand as a result of the strong construction economy and growth in contract size due to cost inflation within the construction industry. Commercial surety and related fidelity and other premiums decreased 1.4 percent to \$127.3 million as a decline in production of notary bonds and notary errors and omissions policies resulting from the loss of a large notary program discussed above offset growth in other commercial and related products.

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

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2006	2005	2006	2005
	-----	-----	-----	-----
Contract	\$ 64,896	\$ 61,732	\$ 192,299	\$ 181,111
Commercial	32,573	32,429	99,304	99,304
Fidelity and other.....	7,598	8,870	24,567	24,567
	-----	-----	-----	-----
	\$ 105,067	\$ 103,031	\$ 316,170	\$ 305,022
	=====	=====	=====	=====

For the quarter ended September 30, 2006, net written premiums increased 2.0 percent to \$105.1 million as compared to the third quarter of 2005, primarily due to the increase in gross written premiums as described above.

For the nine months ended September 30, 2006, net written premiums increased 11.9 percent to \$316.2 million, primarily due to the increase in gross written premiums described above and a decrease in ceded written premiums. Ceded

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written premiums decreased \$9.0 million to \$31.8 million for the first nine months of 2006 compared to the same period last year. This decrease reflects the Company's decision not to renew a high-level excess of loss reinsurance treaty and cost savings on the core reinsurance program.

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.

2006 THIRD PARTY REINSURANCE COMPARED TO 2005 THIRD PARTY REINSURANCE

Effective January 1, 2006, CNA Surety entered into a new excess of loss treaty ("2006 Excess of Loss Treaty") with a group of third party reinsurers on terms similar to the 2005 Excess of Loss Treaty. Under the 2006 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 primary difference between the 2006 Excess of Loss Treaty and the Company's 2005 Excess of Loss Treaty is as follows. The base annual premium for the 2006 Excess of Loss Treaty is \$36.9 million compared to the actual cost of the 2005 Excess of Loss Treaty of \$41.5 million. The contract includes an optional extended discovery period, for an additional premium (a percentage of the original premium based on any unexhausted aggregate limit by layer), which will provide coverage for losses discovered beyond 2006 on bonds that were in force during 2006.

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, 2006 and expires on December 31, 2006 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, 2006 and expires on December 31, 2006 and is annually renewable thereafter. CCC and CIC transfer the related liabilities of such business and pay to Western Surety an amount in cash equal to CCC's and CIC's net written premiums written on all such business, minus a quarterly ceding commission to be retained by CCC and CIC equal to \$50,000 plus 25% of net written premiums written on all such business. This contemplates an approximate 4% override commission for fronting fees to CCC and CIC on their actual direct acquisition costs.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of the Merger Date by agreeing to pay Western Surety, within 30 days following the end of each calendar quarter, the amount of any adverse development on such reserves, as re-estimated as of the end of such calendar quarter. There was no adverse reserve development for the period from September 30, 1997 (date of inception) through September 30, 2006.

Through a stop loss contract entered into at the Merger Date (the "Stop

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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, 2006 and December 31, 2005, the Company had billed and received \$45.9 million under the Stop Loss Contract. As of September 30, 2006, the Company had an estimated unpaid loss recoverable balance of approximately \$2.0 million under the Stop Loss Contract.

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The Company and CCC previously participated in a \$40 million excess of \$60 million reinsurance contract effective from January 1, 2005 to December 31, 2005 providing coverage exclusively for the one large national contractor 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. 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 was from January 1, 2005 to December 31, 2005. In November 2005, the Company and CCC agreed by addendum to extend this contract for twelve months. This extension, expiring December 31, 2006, was for an additional minimum premium of \$0.8 million, subject to adjustment based on the level of actual premiums written on bonds for the large national contractor. As of September 30, 2006 and December 31, 2005, the Company has ceded losses of \$50.0 million under the terms of this contract.

The Company and CCC entered into a \$50 million excess of \$100 million contract for the period of January 1, 2005 to December 31, 2005. The premium for this contract was \$4.8 million plus an additional premium of \$14.0 million if a loss was 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 December 31, 2005, no losses were ceded under this contract, which was not renewed for 2006.

NET LOSS RATIO

The net loss ratio was 20.6% for the three months ended September 30, 2006 as compared with 21.9% for the same period in 2005. The improved loss ratio includes favorable development on prior accident years, as confirmed by our independent loss reserve review, of \$5.1 million or approximately 5 percentage points compared to \$3.4 million or approximately 4 percentage points in the same period last year. The favorable development was primarily due to decreased severity of contract claims in the 2005 accident year.

The net loss ratio was 23.9% for the nine months ended September 30, 2006 as compared with 40.6% for the same period in 2005. The improved loss ratio primarily reflects the absence of the reserve charge related to the large national contractor and overall improved claim experience.

EXPOSURE MANAGEMENT

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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. These initiatives are particularly focused on exposure to large commercial accounts. Large commercial accounts are defined as accounts with exposures in excess of \$10.0 million. "Exposure" is defined as the face amount of the bond. As the following table depicts, the Company has reduced its exposure, before the effects of reinsurance, to large commercial accounts within certain exposure ranges. However, total large commercial account exposure has increased 9.1 percent in the nine months ended September 30, 2006.

	NUMBER OF ACCOUNTS AS OF		TOTAL EXPOSURE (DOLLARS IN AS OF	
	SEPTEMBER 30, 2006	DECEMBER 31, 2005	SEPTEMBER 30, 2006	DECEMBER 31, 2005
COMMERCIAL ACCOUNT EXPOSURE				
\$100 million and larger.....	2	2	\$ 233.6	\$ 246.6
\$50 to \$100 million.....	3	2	193.4	137.6
\$25 to \$50 million.....	7	9	238.1	307.7
\$10 to \$25 million.....	38	32	575.4	445.6
	--	--		
Total.....	50	45	\$ 1,240.5	\$ 1,137.5
	==	==	=====	=====

With respect to contract surety, the Company's portfolio is predominantly comprised of contractors with bonded backlog of less than \$30.0 million. Bonded backlog is 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.

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.

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EXPENSE RATIO

The expense ratio was 55.0% for the three months ended September 30, 2006 as compared with 57.0% for the same period in 2005. The expense ratio was 55.2% for the nine months ended September 30, 2006 as compared with 58.6% for the same period in 2005. The improvement in both ratios reflects the impact of a decrease in ceded earned premium and the strong premium growth accomplished with minimal increases in underwriting expenses.

INVESTMENT INCOME AND REALIZED INVESTMENT GAINS/LOSSES

Net investment income was \$9.8 million for the three months ended September 30, 2006, as compared with \$8.7 million for the same period in 2005. This is due to the increase in invested assets in 2005 and 2006 and higher yields. The annualized pre-tax yield was 4.5% and 4.3% for the three months ended September 30, 2006 and 2005, respectively. The annualized after-tax yield was 3.8% and 3.6% for the three months ended September 30, 2006 and 2005,

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respectively. Net realized investment losses were \$1.0 million for the quarter ended September 30, 2006 compared to net realized investment gains of \$0.1 million in the same period of 2005. This decrease was primarily due to the recognition of impairment losses on certain fixed income securities, which are discussed in detail later in the Financial Condition section of this MD&A.

Net investment income was \$29.0 million for the nine months ended September 30, 2006 as compared with \$24.7 million for the same period in 2005. The increase is due to the impact of higher overall invested assets and higher yields. The annualized pre-tax yields were 4.5% and 4.3% for the nine months ended September 30, 2006 and 2005, respectively. The annualized after-tax yields were 3.7% and 3.6% for the nine months ended September 30, 2006 and 2005, respectively. Net realized investment losses were \$0.9 million for the first nine months of 2006 compared to net realized investment gains of \$2.1 million in the same period of 2005. This decrease was primarily due to the recognition of impairment losses on certain fixed income securities as noted above and the absence of the realized investment gain from the Company's sale of its interest in De Montfort Group, Ltd. in 2005.

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

	THREE MONTHS ENDED SEPTEMBER 30,		NINE SE
	2006	2005	2006
Gross realized investment gains.....	\$ 41	\$ 109	\$ 15
Gross realized investment losses.....	(1,040)	(1)	(1,040)
Net realized investment gains (losses).....	\$ (999)	\$ 108	\$ (89)

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 3.1 percent for the three months ended September 30, 2006 as compared with the same period in 2005, due to higher interest rates associated with the credit facility and the subordinated debentures, partially offset by a reduction in weighted average debt

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outstanding. Weighted average debt outstanding was \$44.1 million for the three months ended September 30, 2006 as compared with \$60.9 million for the same period in 2005. The weighted average interest rate for the three months ended September 30, 2006 was 8.0% as compared with 5.9% for the same period in 2005.

Interest expense increased by 14.9 percent for the nine months ended September 30, 2006 as compared with the same period in 2005. Weighted average debt outstanding was \$48.6 million for the nine months ended September 30, 2006 compared to \$62.6 million in the same period in 2005. The weighted average interest rate for the nine months ended September 30, 2006 was 7.5% as compared with 5.3% for the same period in 2005.

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INCOME TAXES

For the three and nine months ended September 30, 2006, the Company's effective tax rate differs from the statutory tax rate due primarily to tax-exempt investment income. Tax-exempt investment income was \$4.5 million and \$13.3 million for the three and nine months ended September 30, 2006. Tax-exempt investment income was \$4.1 million and \$12.1 million for the three and nine months ended September 30, 2005.

LIQUIDITY AND CAPITAL RESOURCES

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, 2006, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of \$787.0 million of fixed income securities, \$52.7 million of short-term investments, \$0.2 million of other investments and \$2.1 million of cash. At December 31, 2005, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of \$721.3 million of fixed income securities, \$48.4 million of short-term investments, \$1.0 million of other investments and \$4.3 million of cash.

During the first nine months of 2006, the Company paid an additional \$31.9 million related to the surety losses of the large national contractor discussed in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. Through September 30, 2006, the total paid by the Company for surety losses of the large national contractor is \$57.9 million. The Company's exposure, net of expected reinsurance recoveries from CCC, of \$60.0 million was previously fully reserved.

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, 2006, the parent company's invested assets consisted of \$0.8 million of fixed income securities, \$1.6

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million of equity securities, and \$8.6 million of short-term investments and cash. At December 31, 2005, the parent company's invested assets consisted of \$1.0 million of fixed income securities, \$1.3 million of equity securities, and \$19.2 million of short-term investments and cash. At September 30, 2006 and December 31, 2005 respectively, parent company short-term investments and cash included \$6.9 million and \$6.6 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 \$42.9 million for the three months ended September 30, 2006 compared to net cash flow provided by operating activities of \$12.6 million for the comparable period in 2005. The increase in net cash flow provided by operating activities primarily relates to the decrease in operating cash flow in the third quarter of 2005 which resulted from the deposit of \$32.7 million with an affiliate to enable the affiliate to establish a trust to fund future payments under a bond.

The Company's consolidated net cash flow provided by operating activities was \$80.5 million for the nine months ended September 30, 2006 compared to net cash flow provided by operating activities of \$68.4 million for the comparable period in 2005. The increase in net cash flow provided by operating activities primarily relates to increased premiums received and the absence of the payment of \$32.7 million in 2005 to establish the trust discussed above, offset by two commutation receipts which totaled \$24.0 million in the second quarter of 2005, higher loss payments and increased estimated federal income tax payments.

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 provided an aggregate of up to \$50.0 million in borrowings under a revolving credit facility. In the current quarter, the outstanding 2005 Credit Facility balance of \$20.0 million was paid. Also, in September 2006, the Company reduced the available aggregate revolving credit facility to \$25.0 million in borrowings. The 2005 Credit Facility matures on June 30, 2008. No other debt matures in the next five years.

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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%. There was no outstanding balance under the 2005 Credit Facility at September 30, 2006. As such, there was no applicable margin and the weighted average interest rate was 0.325% at September 30, 2006.

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 Company, Inc. ("A.M. Best") 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 as of and for the period ended September 30, 2006.

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 Company's investment of

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\$0.9 million in the Issuer Trust is carried at cost in "Other assets" in the Company's Condensed Consolidated Balance Sheet. 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, 2006 the interest rate on the junior subordinated debenture was 8.78%.

A summary of the Company's commitments as of September 30, 2006 is presented in the following table (in millions):

SEPTEMBER 30, 2006	2006	2007	2008	2009	2010	THER
Debt (a).....	\$ 0.7	\$ 2.8	\$ 2.8	\$ 2.7	\$ 2.7	\$
Operating leases.....	0.5	1.9	1.8	1.7	1.7	
Loss and loss adjustment expense reserves....	33.1	218.6	71.2	28.7	19.5	
Other long-term liabilities (b).....	0.1	1.1	1.0	0.8	0.5	
Total.....	\$ 34.4	\$224.4	\$ 76.8	\$ 33.9	\$ 24.4	\$1

(a) Reflects expected principal and interest payments.

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

As an insurance holding company, CNA Surety is dependent upon dividends and other permitted payments from its insurance subsidiaries to pay operating expenses, 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 Company of America ("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 Universal Surety of America is domiciled, an 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

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surplus and statutory net income. Dividend capacity for 2006 is based on statutory surplus and income at and for the year ended December 31, 2005. Without prior regulatory approval, CNA Surety's insurance subsidiaries may pay stockholder dividends of \$39.1 million in the aggregate in 2006. CNA Surety received dividends of \$10.5 million and \$10.0 million from its insurance subsidiaries during the first nine months of 2006 and 2005, respectively. CNA Surety

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received \$0.1 million in cash from its non-insurance subsidiaries during the first nine months of 2006. CNA Surety received \$1.5 million in dividends, including \$0.5 million in cash, from its non-insurance subsidiaries during the first nine months of 2005.

Combined statutory surplus totaled \$323.4 million at September 30, 2006, resulting in a net written premium to statutory surplus ratio of to 1.2 to 1.0. Insurance regulations restrict Western Surety's maximum net retention on a single surety bond to 10 percent of statutory surplus. Under the 2006 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. Based on statutory surplus as of September 30, 2006, this regulation would limit Western Surety's largest net risk to \$32.3 million. This surplus requirement may limit the amount of future dividends Western Surety could otherwise pay to CNA Surety.

In accordance with the provisions of intercompany tax sharing agreements between CNA Surety and its subsidiaries, the 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. CNA Surety received \$31.4 million and \$11.8 million from its subsidiaries for the nine months ended September 30, 2006 and September 30, 2005, respectively.

Western Surety and Surety Bonding each qualify as an acceptable surety for federal and other public works project bonds pursuant to U.S. Department of Treasury regulations. U.S. Treasury underwriting limitations are based on an insurer's statutory surplus. Effective July 1, 2005 through June 30, 2006, the underwriting limitations of Western Surety and Surety Bonding were \$24.6 million and \$0.7 million, respectively. Effective July 1, 2006 through June 30, 2007, the underwriting limitations of Western Surety and Surety Bonding are \$26.8 million and \$0.7 million, respectively. Through the Quota Share Treaty between CCC and Western Surety, CNA Surety has access to CCC and its affiliates' U.S. Department of Treasury underwriting limitations. Effective July 1, 2005 through June 30, 2006, the underwriting limitations of CCC and its affiliates totaled \$645.7 million. Effective July 1, 2006 through June 30, 2007, the underwriting limitations of CCC and its affiliates total \$635.6 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 obligations and capital needs.

FINANCIAL CONDITION

INVESTMENT PORTFOLIO

The estimated fair value and amortized cost or cost of fixed income and

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equity securities held by CNA Surety at September 30, 2006 and December 31, 2005, by investment category, were as follows (dollars in thousands):

	AMORTIZED	GROSS	GROSS UNREALIZED LOSS	
SEPTEMBER 30, 2006	COST OR	UNREALIZED	LESS THAN	MORE TH
	COST	GAINS	12 MONTHS	12 MONT
Fixed income securities:				
U.S. Treasury securities and obligations of				
U.S. Government and agencies:				
U.S. Treasury.....	\$ 14,846	\$ --	\$ (137)	\$ (15
U.S. Agencies.....	40,030	60	--	(27
Collateralized mortgage obligations.....	17,246	345	--	(33
Mortgage pass-through securities.....	40,446	76	--	(1,23
Obligations of states and political				
subdivisions.....	515,553	13,982	(8)	(
Corporate bonds.....	66,936	1,465	(154)	(1,06
Non-agency collateralized mortgage obligations...	37,068	242	--	(85
Other asset-backed securities:				
Second mortgages/home equity loans.....	20,925	--	(38)	(13
Credit card receivables.....	17,228	252	--	-
Other.....	5,613	70	--	(14
Total fixed income securities.....	775,891	16,492	(337)	(4,19
Equity securities.....	1,447	125	--	-
Total.....	\$777,338	\$ 16,617	\$ (337)	\$ (4,19

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	AMORTIZED	GROSS	GROSS UNREALIZED LOSS	
DECEMBER 31, 2005	COST OR	UNREALIZED	LESS THAN	MORE TH
	COST	GAINS	12 MONTHS	12 MONTHS
-----	-----	-----	-----	-----
Fixed income securities:				
U.S. Treasury securities and obligations				
of U.S. Government and agencies:				
U.S. Treasury.....	\$ 15,637	\$ --	\$ (32)	\$ (15
U.S. Agencies.....	40,055	131	(195)	(8
Collateralized mortgage obligations.....	18,696	432	(223)	--
Mortgage pass-through securities.....	45,607	87	(647)	(45
Obligations of states and political				
subdivisions.....	464,417	14,424	(1,282)	(47
Corporate bonds.....	69,626	1,885	(1,152)	(1
Non-agency collateralized mortgage obligations...	22,200	--	(690)	-
Other asset-backed securities:				
Second mortgages/home equity loans.....	25,924	21	(181)	-
Other.....	5,613	93	(115)	-
Redeemable preferred stock.....	3,000	128	--	-
	-----	-----	-----	-----
Total fixed income securities.....	710,775	17,201	(4,517)	(1,18

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Equity securities.....	1,201	105	--	--
	-----	-----	-----	-----
Total.....	\$711,976	\$ 17,306	\$ (4,517)	\$ (1,18
	=====	=====	=====	=====

The following table summarizes for fixed income securities in an unrealized loss position at September 30, 2006 and 2005, 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, 2006		DECEMBER 31, 2005
UNREALIZED LOSS AGING	ESTIMATED FAIR VALUE	GROSS UNREALIZED LOSS	ESTIMATED FAIR VALUE
-----	-----	-----	-----
Fixed income securities:			
0-6 months.....	\$ 3,583	\$ 4	\$ 224,117
7-12 months.....	32,262	333	32,630
13-24 months.....	125,645	3,616	32,429
Greater than 24 months.....	12,081	581	1,089
	-----	-----	-----
Total.....	\$ 173,571	\$ 4,534	\$ 290,265
	=====	=====	=====

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 other-than-temporary 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 other-than-temporary 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 Income.

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During the third quarter of 2006, the Company recognized impairment losses on 21 municipal fixed income securities that were in an unrealized loss position. In response to the significant change in interest rates in the third quarter, as well as a revised outlook on future interest rates, the Company does not have the intention of holding these securities to their anticipated recovery. The other-than-temporary impairment losses on these securities were \$0.9 million.

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As of September 30, 2006, 65 securities held by the Company were in an unrealized loss position. The Company believes that 64 of these securities are in an unrealized loss position because of changes in interest rates and therefore expects these securities will recover in value at or before maturity. Of these 65 securities, 44 were rated "AAA" by Standard & Poor's ("S&P") and "Aaa" by Moody's Investor Services ("Moody's") and all were investment grade. Two of these 65 securities were in a loss position that exceeded 5% of its book value, with the largest percentage unrealized loss being approximately 6.8% of that security's book value resulting in an unrealized loss of \$0.1 million. The largest unrealized loss was \$0.4 million, which was approximately 4.7% of that security's book value.

The remaining security that was in an unrealized loss position was issued by the financing subsidiary of a large domestic automaker. The security was in an unrealized loss position of approximately 4.9% (\$0.2 million) of its book value and was rated below investment grade by S&P and Moody's. The Company believes that the financial condition and near-term prospects of the issuer are strong, and expects that the unrealized loss will reverse. The Company intends and believes it has the ability to hold this investment until the expected recovery in value, which may be at maturity.

IMPACT OF PENDING ACCOUNTING STANDARDS

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (an amendment of FASB Statements No. 87, 88, 106 and 132(R)) ("SFAS 158"). SFAS 158 requires a company who sponsors one or more single-employer defined benefit plans to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS 158 requires a company to measure benefit plan assets and obligations as of the date of the company's fiscal year-end statement of financial position. SFAS 158 also requires a company to disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The Company is currently evaluating the impact that adopting SFAS 158 will have on our financial condition.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurement" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with GAAP and expands disclosures about fair value measurements. SFAS 157 retains the exchange price notion in the definition of fair value and clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the

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liability in the market in which the reporting entity would transact for the asset or liability. SFAS 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement and the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. SFAS 157 expands disclosures surrounding the use of fair value to measure assets and liabilities and specifically focuses on the sources used to measure fair value. In instances of recurring use of fair value measures using unobservable inputs, SFAS 157 requires separate disclosure of the effect on earnings for the period. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within the year of adoption. The Company is currently evaluating the impact that adopting SFAS 157 will have on our operations and financial condition.

In September 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 requires registrants to use a dual approach to include both a balance sheet approach and an income statement approach when quantifying and evaluating the materiality of a misstatement in a company's financial statements and the related financial statement disclosures. If either approach results in quantifying a misstatement that is material, then a registrant shall adjust the financial statements. SAB 108 provides transition guidance for correcting errors existing in prior years. If prior year errors that had been previously considered immaterial (based on the appropriate use of the registrant's prior approach) now are considered material based on the approach in SAB 108, then the registrant need not restate prior period financial statements. SAB 108 does not change the requirements for the correction of an error discovered in prior year financial statements. Errors discovered in prior year financial statements shall continue to be restated in accordance with SFAS No. 154, "Accounting Changes and Error Correction". SAB 108 is effective for financial statements issued for fiscal years ending after December 15, 2006. Adoption of SAB 108 is not expected to have an impact on the Company's results of operations or financial condition.

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In July 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. FIN 48 states that a tax benefit from an uncertain position may be recognized only if it is "more likely than not" that the position is sustainable, based on its technical merits. The tax benefit of a qualifying position is the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority having full knowledge of all relevant information. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact that adopting FIN 48 will have on the Company's results of operations and financial condition.

In January 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments" ("SFAS 155"). SFAS 155 amends FASB Statements No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"), and No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities". SFAS 155 also resolves issues addressed in SFAS 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets". SFAS 155 will improve financial reporting by eliminating the exemption from applying SFAS 133 to interests in securitized financial assets so that similar instruments are accounted for in the same manner regardless of the form of the instruments. SFAS

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155 will also improve financial reporting by allowing a preparer to elect fair value measurement at acquisition, at issuance, or when a previously recognized financial instrument is subject to a re-measurement (new basis) event, on an instrument-by-instrument basis. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of SFAS 155 may also be applied upon adoption of SFAS 155 for hybrid financial instruments that had been bifurcated under paragraph 12 of SFAS 133 prior to the adoption of this Statement. Provisions of SFAS 155 may be applied to instruments that an entity holds at the date of adoption on an instrument-by-instrument basis. Adoption of this standard is not expected to have a material impact on the Company's results of operations or financial condition.

In September 2005, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants issued Statement of Position, "Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts" ("SOP 05-01"). SOP 05-01 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in SFAS No. 97, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments". SOP 05-01 defines an internal replacement as a modification in product benefits, features, rights, or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or rider to a contract, or by the election of a feature or coverage within a contract. SOP 05-01 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact that adopting SOP 05-01 will have on the Company's results of operations and financial condition.

FORWARD-LOOKING STATEMENTS

This report includes a number of statements, which relate to anticipated future events (forward-looking statements) rather than actual present conditions or historical events. Forward-looking statements generally include words such as "believes," "expects," "intends," "anticipates," "estimates," and similar expressions. Forward-looking statements in this 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;
- 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

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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, 2006. 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.

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	FAIR VALUE AT SEPTEMBER 30, 2006	HYPOTHETICAL CHANGE IN INTEREST RATE (BP=BASIS POINTS)
	-----	-----
		(DOLLARS IN T
U.S. Government and government agencies and authorities..	\$ 110,913	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
States, municipalities and political subdivisions.....	529,523	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
Corporate bonds and all other.....	147,413	200 bp increase

		100 bp increase
		100 bp decrease
		200 bp decrease
Total fixed income securities available-for-sale.....	\$ 787,849	200 bp increase
	=====	
		100 bp increase
		100 bp decrease
		200 bp decrease

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	FAIR VALUE AT DECEMBER 31, 2005	HYPOTHETICAL CHANGE IN INTEREST RATE (BP=BASIS POINTS)
	-----	-----
		(DOLLARS IN T
U.S. Government and government agencies and authorities..	\$ 118,856	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
States, municipalities and political subdivisions.....	477,084	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
Corporate bonds and all other.....	126,339	200 bp increase

		100 bp increase
		100 bp decrease
		200 bp decrease
Total fixed income securities available-for-sale.....	\$ 722,279	200 bp increase
	=====	
		100 bp increase
		100 bp decrease
		200 bp decrease

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ITEM 4. CONTROLS AND PROCEDURES

The Company maintains a system of disclosure controls and procedures which are designed to ensure that information required to be disclosed by the Company in reports that it files or submits to the Securities and Exchange Commission under the Securities 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 1A. RISK FACTORS - Information on the Company's risk factors is set forth

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in Item 1A "Risk Factors" in the Company's Annual Report on Form 10-K for the year-ended December 31, 2005.

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 31, 2006; CNA Surety Corporation Earnings Press Release issued on July 31, 2006.

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ITEM 6. EXHIBITS

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.....
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.....
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.....
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.....

* Exhibits 32.1 and 32.2 are being furnished and shall not be deemed "filed" for the purpose of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liabilities of that Section. These Exhibits shall not be incorporated by reference into any registration statement or other document pursuant to the Securities Act of 1933, as amended.

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SIGNATURES

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

CNA SURETY CORPORATION (Registrant)

/s/ John F. Welch

John F. Welch
President and Chief Executive Officer

/s/ John F. Corcoran

John F. Corcoran
Senior Vice President and Chief Financial Officer

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Date: October 31, 2006

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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.

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