CNA SURETY CORP
Form 10-Q
October 24, 2008

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

FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2008
OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________
Commission file number: 1-13277
CNA SURETY CORPORATION
(Exact name of Registrant as specified in its Charter)

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

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

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

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

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

44,162,297 shares of Common Stock, $.01 par value as of October 20, 2008.

CNA SURETY CORPORATION AND SUBSIDIARIES
INDEX

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

	September 30, 2008	December 31, 2007
ASSETS		
Invested assets:		
Fixed income securities, at fair value (amortized cost: $996,802 and $949,708)	$ 965,470	$ 963,354
Equity securities, at fair value (cost: $1,405 and $1,683)	1,405	1,789
Short-term investments, at cost (approximates fair value)	82,909	49,453
Total invested assets	1,049,784	1,014,596
Cash	8,774	10,230
Deferred policy acquisition costs	106,961	104,280
Insurance receivables:		
Premiums, including $11,981 and $12,317 from affiliates, (net of allowance for doubtful accounts: $965 and $1,145)	45,149	36,317
Reinsurance, including $46,794 and $50,547 from affiliates	94,360	127,119
Deposit with affiliated ceding company	30,852	34,644
Intangible assets (net of accumulated amortization: $25,523 and $25,523)	138,785	138,785
Current income taxes receivable		1,960
Property and equipment, at cost (less accumulated depreciation and amortization: $32,011 and $29,467)	23,878	24,288
Prepaid reinsurance premiums (including $108 and $322 from affiliates)	319	510
Accrued investment income	12,262	12,242
Other assets	2,668	2,683
Total assets	$ 1,513,792	$ 1,507,654
LIABILITIES		
Reserves:		
Unpaid losses and loss adjustment expenses	$ 424,561	$ 472,842
Unearned premiums	271,551	258,930
Total reserves	696,112	731,772
Debt	30,867	30,791
Deferred income taxes, net	2,552	17,756
Reinsurance and other payables to affiliates	460	643
Accrued expenses	16,972	18,273
Liability for postretirement benefits	8,764	10,001
Federal income tax payable	6,490	
Other liabilities	29,344	30,713
Total liabilities	791,561	839,949

Commitments and contingencies (See Notes 3, 4 & 7)

STOCKHOLDERS EQUITY		
Common stock, par value $.01 per share, 100,000 shares authorized; 45,535 shares issued and 44,159 shares outstanding at September 30, 2008 and 45,505 shares issued and 44,121 shares outstanding at December 31, 2007	455	455
Additional paid-in capital	275,778	274,069
Retained earnings	480,526	399,241
Accumulated other comprehensive income (loss)	(19,755)	8,800
Treasury stock, 1,376 and 1,384 shares, at cost	(14,773)	(14,860)
Total stockholders equity	722,231	667,705
Total liabilities and stockholders equity	$ 1,513,792	$ 1,507,654

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Revenues:				
Net earned premium	$ 109,696	$ 113,617	$ 320,814	$ 317,607
Net investment income	11,781	11,328	35,292	32,792
Net realized investment (losses) gains	(177)	65	(207)	(486)
Total revenues	121,300	125,010	355,899	349,913
Expenses:				
Net losses and loss adjustment expenses	8,745	23,835	62,103	75,632
Net commissions, brokerage and other underwriting expenses	61,694	59,952	174,806	170,870
Interest expense	508	745	1,659	2,194
Total expenses	70,947	84,532	238,568	248,696
Income before income taxes	50,353	40,478	117,331	101,217
Income tax expense	16,020	12,481	36,046	30,577
Net income	$ 34,333	$ 27,997	$ 81,285	$ 70,640
Earnings per common share	$ 0.78	$ 0.64	$ 1.84	$ 1.61
Earnings per common share, assuming dilution	$ 0.78	$ 0.63	$ 1.84	$ 1.60
Weighted average shares outstanding	44,138	43,954	44,139	43,975
Weighted average shares outstanding, assuming dilution	44,264	44,194	44,258	44,248

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

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

	Common Stock Shares Outstanding	**Common Stock**	**Additional Paid-In Capital**	**Comprehensive Income (Loss)**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Treasury Stock At Cost**	**Total Stockholders Equity**
Balance, December 31, 2006	43,872	$ 453	$ 268,651		$ 306,745	$ 4,993	$ (14,940)	$ 565,902
Comprehensive income:								
Net income				$ 70,640	70,640			70,640
Other comprehensive income:								
Change in unrealized gains on securities, after income tax benefit of $2,042 (net of reclassification adjustment of ($120), after income tax benefit of $65)				(3,793)		(3,793)		(3,793)
Adjustment to recognize re-measurement of accumulated postretirement benefit obligations, net of tax benefit of $563				(684)		(684)		(684)
Adjustment to postretirement benefit plan net periodic cost, after income tax expense of $74				137		137		137
Total comprehensive income				$ 66,300				

Stock-based compensation			1,456					1,456
Stock options exercised and other	150	1	2,146				80	2,227
Balance, September 30, 2007	44,022	$ 454	$ 272,253		$ 377,385	$ 653	$ (14,860)	$ 635,885
Balance, December 31, 2007	44,121	$ 455	$ 274,069		$ 399,241	$ 8,800	$ (14,860)	$ 667,705
Comprehensive income:								
Net income				$ 81,285	81,285			81,285
Other comprehensive income:								
Change in unrealized gains (losses) on securities, after income tax benefit of $15,779 (net of reclassification adjustment of $8, after income tax expense of $5)				(29,304)		(29,304)		(29,304)
Adjustment to recognize re-measurement of accumulated postretirement benefit obligations, after income tax expense of $778				828		828		828
Net change related to postretirement benefits, after income tax benefit of $42				(79)		(79)		(79)
Total comprehensive income				$ 52,730				

Stock-based compensation			1,327				1,327
Stock options exercised and other	38		382			87	469
Balance, September 30, 2008	44,159	$ 455	$ 275,778	$ 480,526	$ (19,755)	$ (14,773)	$ 722,231

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

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

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 81,285	$ 70,640
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for doubtful accounts	(38)	332
Depreciation and amortization	4,238	4,723
Amortization (accretion) of bond premium (discount), net	2,007	(70)
Loss on disposal of property and equipment	1,130	1
Net realized investment losses	207	486
Stock-based compensation	1,327	1,456
Changes in:		
Insurance receivables	23,965	(6,075)
Reserve for unearned premiums	12,621	19,947
Reserve for unpaid losses and loss adjustment expenses	(48,281)	13,234
Deposits with affiliated ceding company	3,792	(1,134)
Deferred policy acquisition costs	(2,681)	(5,863)
Deferred income taxes, net	(202)	(1,097)
Reinsurance and other payables to affiliates	(183)	2,061
Prepaid reinsurance premiums	191	1,413
Accrued expenses	(1,301)	(5,163)
Other assets and liabilities	7,167	(3,570)
Net cash provided by operating activities	85,244	91,321
CASH FLOWS FROM INVESTING ACTIVITIES:		
Fixed income securities:		
Purchases	(99,751)	(224,087)
Maturities	25,602	46,459
Sales	24,402	70,103
Purchases of equity securities	(370)	(714)
Proceeds from the sale of equity securities	460	757
Changes in short-term investments	(32,830)	28,069
Purchases of property and equipment, net	(4,882)	(4,696)
Other, net	200	(29)
Net cash used in investing activities	(87,169)	(84,138)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Employee stock option exercises and other	469	2,227

Net cash provided by financing activities		469		2,227
(Decrease) increase in cash		(1,456)		9,410
Cash at beginning of period		10,230		7,164
Cash at end of period	$	8,774	$	16,574
Supplemental Disclosure of Cash Flow Information:				
Cash paid during the period for:				
Interest	$	1,665	$	2,110
Income taxes	$	27,741	$	26,898

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

CNA SURETY CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2008
(UNAUDITED)

1. Significant Accounting Policies

Formation of CNA Surety Corporation and Merger

In December 1996, CNA Financial Corporation (CNAF) and Capsure Holdings Corp. (Capsure) agreed to merge (the Merger) the surety business of CNAF with Capsure s insurance subsidiaries, Western Surety Company (Western Surety), Surety Bonding Company of America (Surety Bonding) and Universal Surety of America (Universal Surety), into CNA Surety Corporation (CNA Surety or the Company). CNAF, through its operating subsidiaries, writes multiple lines of property and casualty insurance, including surety business that is reinsured by Western Surety. CNAF owns approximately 62% of the outstanding common stock of CNA Surety. Loews Corporation (Loews) owns approximately 90% 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).

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 2007 Form 10-K. Certain financial information that is included in annual financial statements prepared in accordance with GAAP is not required for interim reporting and has been condensed or omitted. The accompanying unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all adjustments necessary for a fair presentation of the interim financial statements. All such adjustments are of a normal and recurring nature. The financial results for interim periods may not be indicative of financial results for a full year.

Earnings Per Share

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net income	$ 34,333	$ 27,997	$ 81,285	$ 70,640
Shares:				
Weighted average shares outstanding	44,132	43,938	44,121	43,872
Weighted average shares of options exercised and additional stock issuance	6	16	18	103
Total weighted average shares outstanding	44,138	43,954	44,139	43,975
Effect of dilutive options	126	240	119	273
Total weighted average shares outstanding, assuming dilution	44,264	44,194	44,258	44,248
Earnings per share	$ 0.78	$ 0.64	$ 1.84	$ 1.61
Earnings per share, assuming dilution	$ 0.78	$ 0.63	$ 1.84	$ 1.60

No adjustments were made to reported net income in the computation of earnings per share. Options to purchase shares of common stock of 0.6 million were excluded from the calculation of diluted earnings per share for both the three and nine months ended September 30, 2008 because the exercise price of these options was greater than the average market price of CNA Surety s common stock. Options to purchase shares of common stock of 0.3 million were excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2007 because the exercise price of the options was greater than the average market price of the Company s common stock.

Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (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 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. For fiscal years beginning after November 15, 2007, companies are required to implement the standard for financial assets and liabilities, as well as for any other assets and liabilities that are carried at fair value on a recurring basis in financial statements. In February 2008, the FASB issued Staff Position SFAS 157-2, Effective Date of FASB Statement No. 157 (FSP SFAS 157-2), which delays the effective date of SFAS 157 for all nonrecurring fair value measurements of nonfinancial assets and nonfinancial liabilities until fiscal years beginning after November 15, 2008. In October 2008, the FASB issued Staff Position SFAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active (FSP SFAS 157-3), which clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate in determining fair value in that market. FSP SFAS 157-3 was effective immediately upon issuance.

The Company adopted SFAS 157 on January 1, 2008 for its financial assets and liabilities. Overall, the impact of adopting SFAS 157 did not have a significant impact on the financial condition at the date of adoption or the results of operations for the three and nine months ended September 30, 2008.

2. Investments

The estimated fair value and amortized cost or cost of fixed income and equity securities held by CNA Surety at September 30, 2008 and December 31, 2007, by investment category, were as follows (dollars in thousands):

September 30, 2008	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses Less Than 12 Months	Gross Unrealized Losses More Than 12 Months	Estimated Fair Value
Fixed income securities:					
U.S. Treasury securities and obligations of U.S. Government and agencies:					
U.S. Treasury	$ 17,744	$ 820	$	$	$ 18,564
U.S. Agencies	54,599	504	(9)		55,094
Collateralized mortgage obligations	30,331	395	(235)		30,491
Mortgage pass-through securities	73,648	423	(266)	(386)	73,419
Obligations of states and political subdivisions	651,811	7,027	(12,110)	(14,648)	632,080
Corporate bonds	97,033	219	(4,830)	(4,077)	88,345
Non-agency collateralized mortgage obligations	35,036		(442)	(2,096)	32,498
Other asset-backed securities:					
Second mortgages/home equity loans	8,600		(118)	(472)	8,010
Credit card receivables	17,238	1	(794)		16,445
Other	10,762	25	(263)		10,524
Total fixed income securities	996,802	9,414	(19,067)	(21,679)	965,470
Equity securities	1,405				1,405
Total	$ 998,207	$ 9,414	$ (19,067)	$ (21,679)	$ 966,875

December 31, 2007	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses Less Than 12 Months	Gross Unrealized Losses More Than 12 Months	Estimated Fair Value
Fixed income securities:					
U.S. Treasury securities and obligations of U.S. Government and agencies:					
U.S. Treasury	$ 17,790	$ 485	$	$	$ 18,275
U.S. Agencies	52,617	706		(15)	53,308
Collateralized mortgage obligations	30,086	502	(11)	(107)	30,470
Mortgage pass-through securities	54,659	401		(586)	54,474

Obligations of states and political subdivisions	625,858	15,408	(2,500)	(641)	638,125
Corporate bonds	95,714	1,493	(97)	(1,408)	95,702
Non-agency collateralized mortgage obligations	35,011	232		(699)	34,544
Other asset-backed securities:					
Second mortgages/home equity loans	9,951			(50)	9,901
Credit card receivables	17,234	451			17,685
Other	10,788	157		(75)	10,870
Total fixed income securities	949,708	19,835	(2,608)	(3,581)	963,354
Equity securities	1,683	106			1,789
Total	$ 951,391	$ 19,941	$ (2,608)	$ (3,581)	$ 965,143

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 which are included in net investment income. Changes in fair value are reported as a component of other comprehensive income, exclusive of other-than-temporary impairment losses, if any.

During the third quarter of 2008, the Company recorded other than temporary impairment losses of $0.2 million on the equity securities that are related to the Company s non-qualified deferred compensation plan. Other than temporary impairment losses for the nine months ended September 30, 2008 were also $0.2 million as no other than temporary impairments were recorded through the second quarter of 2008.

No other than temporary impairments were recorded for the three months ended September 30, 2007. During the second quarter of 2007, the Company recorded other than temporary impairment losses of $0.9 million on 13 fixed income securities of various categories of investments that were in an unrealized loss position. These impairment losses were recognized as significant interest rate changes and a revised outlook on the interest rates resulted in the Company s intention not to hold these securities to their anticipated recovery. These securities were sold during the third quarter of 2007.

As of September 30, 2008, 125 fixed income securities held by the Company were in an unrealized loss position. The Company believes that 119 of these securities are in an unrealized loss position due to general market disruptions, the relative performance and changing market views of asset classes and changes in interest rates. However, the Company believes there are no credit issues specific to these individual securities. Therefore, the Company expects these securities will recover in value at or before maturity. All of these 119 securities are investment grade. 48 of these securities were rated AA by Standard & Poor s (S&P) or Aa1, Aa2, or Aa3 by Moody s Investor Services (Moody s). 5 of these securities were rated AAA by S&P or Aaa by Moody s. Of these 119 securities, 51 were in a loss position that exceeded 5% of its book value, with the largest unrealized loss percentage being 38.8% of that security s book value resulting in an unrealized loss of $1.2 million. The largest unrealized loss was $1.5 million, which was 14.4% of that security s book value.

Of the six remaining securities that were in an unrealized loss position, one was issued by the financing subsidiary of a large domestic automaker. The security was in an unrealized loss position of 33.9% ($1.4 million) of its book value and was rated below investment grade by S&P and Moody s. One of the other securities, rated investment grade by S&P and Moody s, was issued by a large student loan provider and was in an unrealized loss position of 38.5% ($1.2 million) of its book value. Another of these securities was an asset-backed security collateralized by sub-prime home loans. This security, rated investment grade by Moody s but below investment grade by S&P, was in an unrealized loss position of 10.2% ($0.5 million) of its book value. The three remaining securities, rated investment grade by S&P and Moody s, were issued by governmental utility authorities and were in an unrealized loss position of 20.9% ($1.1 million), 25.5% ($2.8 million) and 26.8% ($1.5 million), respectively. The Company believes that the financial condition of these issuers is strong and expects that these unrealized losses will reverse at or before maturity.

The Company intends and believes it has the ability to hold these investments 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.

3. Reinsurance

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

	Three Months Ended September 30,			
	2008		**2007**	
	Written	**Earned**	**Written**	**Earned**
Direct	$ 94,407	$ 94,163	$ 93,169	$ 93,729
Assumed	25,955	27,267	30,380	29,735
Ceded	(11,557)	(11,734)	(9,572)	(9,847)
	$ 108,805	$ 109,696	$ 113,977	$ 113,617

	Nine Months Ended September 30,			
	2008		**2007**	
	Written	**Earned**	**Written**	**Earned**
Direct	$ 280,784	$ 267,087	$ 280,916	$ 262,353
Assumed	80,515	81,591	86,986	85,602
Ceded	(27,673)	(27,864)	(28,935)	(30,348)

	$ 333,626	$ 320,814	$ 338,967	$ 317,607

Assumed premiums primarily includes all surety business written or renewed, net of reinsurance, by CCC and CIC, and their affiliates, after September 30, 1997 that is reinsured by Western Surety pursuant to reinsurance and related agreements. Because of certain regulatory restrictions that limit the Company s ability to write 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 business assumed from these affiliates.

Assumed premium also includes surety business written by another affiliate, First Insurance Company of Hawaii, Ltd. and its subsidiaries First Indemnity Insurance of Hawaii, Inc., First Fire and Casualty Insurance of Hawaii, Inc. and First Security Insurance of Hawaii, Inc. (collectively, FICOH). CNAF owns approximately 50% of the outstanding common stock of First Insurance Company of Hawaii, Ltd. Under the terms of this excess of loss agreement that covers certain contract business, FICOH retains losses of $2 million per principal and Western Surety assumes 80% of $5 million per principal subject to an aggregate annual limit of $8 million. Premiums assumed by Western Surety under this agreement were less than $0.1 million for both the three months ended September 30, 2008 and 2007, respectively, and $0.1 million for both the nine months ended September 30, 2008 and 2007, respectively.

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

	Three Months Ended September 30,			
	2008		2007	
	$	Ratio	$	Ratio
Gross losses and loss adjustment expenses	$ 21	0.2%	$ 20,828	16.9%
Ceded amounts	8,724	(74.3)%	3,007	(30.5)%
Net losses and loss adjustment expenses	$ 8,745	8.0%	$ 23,835	21.0%

	Nine Months Ended September 30,			
	2008		2007	
	$	Ratio	$	Ratio
Gross losses and loss adjustment expenses	$ 70,559	20.2%	$ 79,401	22.8%
Ceded amounts	(8,456)	30.4%	(3,769)	12.4%
Net losses and loss adjustment expenses	$ 62,103	19.4%	$ 75,632	23.8%

During the three months ended September 30, 2008 and 2007, the Company, based on actuarial reviews performed during the respective quarters, reduced gross reserves related to prior accident years by approximately $33.3 million and $11.4 million, respectively. These adjustments reflect changes in estimates of incurred-but-not-reported reserves. The corresponding change in ceded reserves was such that net reserves related to prior accident years were reduced by $24.9 million and $5.0 million for the three months ended September 30, 2008 and 2007, respectively. These actions resulted in the unusual relationships in the gross and ceded amounts shown above.

2008 Third Party Reinsurance Compared to 2007 Third Party Reinsurance

Effective January 1, 2008, CNA Surety entered into a new excess of loss treaty (2008 Excess of Loss Treaty) with a group of third party reinsurers on terms similar to the 2007 Excess of Loss Treaty. Under the 2008 Excess of Loss Treaty, the Company s net retention per principal remained at $10 million with a 5% co-participation in the $90 million layer of third party reinsurance coverage above the Company s retention. The contract provides aggregate coverage of $185 million and includes an optional extended discovery period, for an additional premium (a percentage of the original premium based on any unexhausted aggregate limit by layer), which will provide coverage for losses discovered beyond 2008 on bonds that were in force during 2008. The contract also includes a provision for additional premiums based on losses ceded under the contract. The primary difference between the 2008 Excess of Loss Treaty and the Company s 2007 Excess of Loss Treaty is as follows. The base annual premium for the 2008 Excess of Loss Treaty is $33.3 million compared to the base annual cost of the 2007 Excess of Loss Treaty of $38.3 million before additional premium resulting from loss activity. The Company has incurred additional ceded premiums due to losses ceded under the 2007 Excess of Loss Treaty of $8.5 million, including $4.2 million of additional ceded premium for the three and nine months ended September 30, 2008. Only the large national contractor that was excluded from the 2007 treaty remained excluded from the 2008 Excess of Loss Treaty.

Related Party Reinsurance

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

The Services and Indemnity Agreement provides the Company s insurance subsidiaries with the authority to perform various administrative, management, underwriting and claim functions in order to conduct the 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, 2008 and expires on December 31, 2008 and is annually renewable thereafter.

Through 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, 2008 and expires on December 31, 2008 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, 2008.

Through the Stop Loss Contract, the Company s insurance subsidiaries were protected from adverse loss experience on certain business underwritten after the Merger Date. The Stop Loss Contract between the insurance subsidiaries and CCC limited the insurance subsidiaries prospective net loss ratios with respect to certain accounts and lines of insured business for three full accident years following the Merger Date. In the event the insurance subsidiaries accident year net loss ratio exceeds 24% in any of the accident years 1997 through 2000 on certain insured accounts (the Loss Ratio Cap), the Stop Loss Contract requires CCC at the end of each calendar quarter following the Merger Date, to pay to the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which the Company s actual accident year net loss ratio exceeds the applicable Loss Ratio Cap, multiplied by (ii) the applicable net earned premiums. In consideration for the coverage provided by the Stop Loss Contract, the insurance subsidiaries paid to CCC an annual premium of $20,000. The CNA Surety insurance subsidiaries have paid CCC all required annual premiums. As of December 31, 2007, the net amount billed and received by the Company under the Stop Loss Contract was $42.3 million. This amount included $24.0 million held by the Company for losses covered by this contract that were incurred but not paid as of December 31, 2007. As of September 30, 2008, losses incurred under the Stop Loss Contract were $49.6 million. This amount includes anticipated indemnification recoveries expected for subject losses. CCC has paid all amounts due under the Stop Loss Contract as of September 30, 2008, net of $2.0 million related to expected recoveries.

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 was 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, which expired on 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. In January 2007, the Company and CCC agreed by addendum to extend this contract for another twelve months. This extension, which expired on December 31, 2007, was for an additional premium of $0.5 million, which was based on the level of actual premiums written on bonds for the large national contractor. In December 2007, the Company and CCC agreed by addendum to extend this contract for another twelve months. This extension, which will expire on December 31, 2008, was for an additional premium subject to the level of actual premiums written on bonds for the large national contractor. As of both September 30, 2008 and December 31, 2007, the Company had ceded losses of $50.0 million under the terms of this contract, with unpaid ceded losses of $46.8 million.

As of September 30, 2008 and December 31, 2007, CNA Surety had an insurance receivable balance from CCC and CIC of $58.8 million and $62.9 million, respectively. At September 30, 2008, this receivable included $46.8 million of reinsurance recoverables, and $12.0 million of premiums receivable. At December 31, 2007, this receivable included $50.5 million of reinsurance recoverables and $12.4 million of premiums receivable. CNA Surety had reinsurance payables to CCC and CIC of less than $0.1 million and $0.1 million at September 30, 2008 and December 31, 2007, respectively.

4. Fair Value of Financial Instruments

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

Level 1 Quoted prices for identical instruments in active markets.

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

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

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

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

Fixed Income Securities

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

Equity Securities

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

Short-Term Investments

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

Assets measured at fair value on a recurring basis are summarized below (amounts in thousands):

	September 30, 2008 Fair Value Measurements Using			
	Level 1	**Level 2**	**Level 3**	**Assets at Fair Value**
Assets:				
Fixed income securities at fair value	$ 18,564	$ 946,906		$ 965,470
Equity securities at fair value	1,405			1,405
Short term investments at fair value (a)	48,929	33,980		82,909
Total assets	$ 68,898	$ 980,886		$ 1,049,784

(a)

Includes commercial paper and money market instruments.

The Company had no assets or liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) at either the adoption of SFAS 157 on January 1, 2008 or at September 30, 2008.

5. Reserves for Losses and Loss Adjustment Expenses

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Reserves at beginning of period:				
Gross	$ 495,041	$ 435,569	$ 472,842	$ 434,224
Ceded reinsurance	152,296	142,976	150,496	144,858
Net reserves at beginning of period	342,745	292,593	322,346	289,366
Net incurred loss and loss adjustment expenses:				
Provision for insured events of current year	33,685	28,863	87,104	80,710
Decrease in provision for insured events of prior years	(24,940)	(5,028)	(25,001)	(5,078)
Total net incurred	8,745	23,835	62,103	75,632
Net payments attributable to:				
Current year events	3,456	1,470	5,996	7,044
Prior year events	5,854	5,852	36,273	48,848
Total net payments	9,310	7,322	42,269	55,892
Net reserves at end of period	342,180	309,106	342,180	309,106
Ceded reinsurance at end of period	82,381	138,352	82,381	138,352
Gross reserves at end of period	$ 424,561	$ 447,458	$ 424,561	$ 447,458

6. Debt

In May 2004, the Company, through a wholly-owned trust, privately issued $30.0 million of preferred securities through two pooled transactions. These securities bear interest at a rate of LIBOR plus 337.5 basis points with a 30-year term and are redeemable at par value 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 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 approximately $80.0 million, consisting of annual dividend payments of $1.9 million over 26 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 junior subordinated debenture bears interest at a rate of LIBOR plus 337.5 basis points and matures in April 2034. As of September 30, 2008 and 2007, the interest rate on the junior subordinated debenture was 6.179% and 8.933% respectively.

On June 30, 2008 the Company s credit facility matured. There was no outstanding balance under this facility (the 2005 Credit Facility) during 2008. The 2005 Credit Facility was entered into on July 27, 2005, when the Company refinanced $30.0 million in outstanding borrowings under its previous credit facility. The 2005 Credit Facility provided an aggregate of up to $50.0 million in borrowings under a revolving credit facility. In September 2006, the Company reduced the available aggregate revolving credit facility to $25.0 million in borrowings. The 2005 Credit Facility also contained certain conditions and limitations on the Company. The Company was in compliance with all covenants as of and for the three and nine months ended September 30, 2007 and for the six months ended June 30, 2008 when the 2005 Credit Facility matured.

The term of borrowings under the 2005 Credit Facility was fixed, at the Company s option, for a period of one, two, three, or six months. The interest rate was based on, among other rates, the London Interbank Offered Rate (LIBOR) plus the applicable margin. The margin, including a utilization fee, varied based on the Company s leverage ratio (debt to total capitalization) from 0.80% to 1.00%. There was no outstanding balance under the 2005 Credit Facility during the three and nine months ended September 30, 2007. As such, the Company incurred only the facility fee of 0.300% at September 30, 2007.

7. Employee Benefits

Western Surety sponsors two postretirement benefit plans covering certain employees. One plan provides medical benefits and the other plan provides sick leave termination payments. The medical benefit plan provides coverage for employees, and their eligible dependents, hired by Western Surety before November 1, 1991 and who retire at age 55 or later with at least 15 years of service. Only employees hired by Western Surety prior to 1988 are eligible for the sick leave plan. Further, benefits for the sick leave plan are based on unused accrued sick leave as of December 31, 2003, the date the accruals were frozen. The postretirement medical benefit plan is contributory and the sick leave plan is non-contributory. Western Surety uses a December 31 measurement date for both of its postretirement benefit plans. There were no plan assets for either of the postretirement benefit plans.

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

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2008	**2007**	**2008**	**2007**
Net periodic benefit cost:				
Service cost	$ 26	$ 97	$ 144	$ 250
Interest cost	74	227	364	572
Amortization of prior service cost	(68)		(121)	(80)
Net amortization of actuarial (gain) loss	(12)	127		290
Net periodic benefit cost	$ 20	$ 451	$ 387	$ 1,032

The Company uses a roll-forward technique to develop its year-end measurement of the accumulated postretirement benefit obligation and subsequently performs a valuation as of January 1 of the following year using updated data. This valuation was completed during the third quarter of 2008. As a result, in the third quarter of 2008, the liability for postretirement benefits and the 2008 net periodic benefit costs have been adjusted. The postretirement benefit liability decreased by $1.6 million. Net periodic benefit costs also decreased $0.2 million for the three months ended September 30, 2008 due to this remeasurement. These decreases were driven by lower expected per capita claims costs for the medical benefit plan related to changes in the plan provider.

As a result of adopting 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) as of December 31, 2006, amortization of prior service costs and net actuarial (gains)/losses recognized through the statement of income are also adjusted through other comprehensive income.

The Company expects to contribute $0.3 million to the postretirement benefit plans to pay benefits in 2008. As of September 30, 2008, $0.1 million of contributions have been made to the postretirement benefit plans.

8. Commitments and Contingencies

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

9. Income Taxes

The Internal Revenue Service is currently examining the Company s tax return for the year 2006. Management believes the ultimate resolution of this examination will not result in a material adverse effect to the Company s financial position or results of operations.

10. Stockholders Equity

The compensation expense recorded for the Company s stock-based compensation plan was $0.4 million and $0.5 million for the three months ended September 30, 2008 and 2007, respectively, and $1.3 million and $1.5 million for the nine months ended September 30, 2008 and 2007, respectively. The total income tax benefit recognized in the statement of income for stock-based compensation arrangements was $0.2 million for both the three months ended

September 30, 2008 and 2007, respectively. The total income tax benefit recognized in the statement of income for stock-based compensation was $0.5 million for both the nine months ended September 30, 2008 and 2007, respectively . The amount of cash received from the exercise of stock options was $0.2 million for the three months ended September 30, 2008 and $0.4 million for the three months ended September 30, 2007. For the nine months ended September 30, 2008 and 2007, the amount of cash received was $0.4 million and $2.2 million, respectively.

Equity Compensation Plans

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

The 2006 Plan is administered by 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 four-year period following the date of grant.

On February 8, 2008, 259,380 options were granted under the 2006 Plan. The fair market value (at grant date) per option granted was $6.32 for these options. The fair value of these options was estimated at grant date using a Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate of 2.7%; dividend yield of 0.0%; expected option life of 5.3 years; and volatility of 38.3%. The Company estimated the expected option life of the 2008 grant based on its analysis of past exercise patterns for similar options and did not use the simplified method used for estimating the expected option life of the 2007 grant described below. As of September 30, 2008, the number of shares available for granting of options under the 2006 Plan was 2,434,905.

On February 13, 2007, 334,100 options were granted under the 2006 Plan. The fair market value (at grant date) per option granted was $9.04 for these options. The fair value of these options was estimated at grant date using a Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate of 4.8%; dividend yield of 0.0%; expected option life of 6.3 years; and volatility of 34.7%. The Company estimated the expected option life using the simplified method allowed under the Securities and Exchange Commission s Staff Accounting Bulletin (SAB) No. 107 (SAB 107). The Company s stock options qualify for this method based on the criteria defined in SAB 107.

A summary of option activity for the nine months ended September 30, 2008 and 2007 is presented below:

	Shares Subject To Option	Weighted Average Exercise Price Per Share
Outstanding options at January 1, 2007	1,008,525	$12.02
Options granted	334,100	$20.70
Options forfeited	(32,075)	$14.36
Options expired	(790)	$15.20
Options exercised	(141,160)	$12.49
Outstanding options at September 30, 2007	1,168,600	$14.38
Outstanding options at January 1, 2008	1,054,588	$14.53

Options granted	259,380	$16.35
Options forfeited	(22,210)	$16.99
Options expired	(6,125)	$12.71
Options exercised	(29,800)	$11.53
Outstanding options at September 30, 2008	1,255,833	$14.94

A summary of the status of the Company s non-vested options as of September 30, 2008 and 2007 and changes during the nine months then ended is presented below:

	Shares Subject To Option	Weighted Average Grant Date Fair Value
Non-vested options at January 1, 2007	481,613	$ 4.51
Options granted	334,100	$ 9.04
Options vested	(14,750)	$ 3.73
Options forfeited	(32,075)	$ 5.67
Non-vested options at September 30, 2007	768,888	$ 6.45
Non-vested options at January 1, 2008	554,557	$ 7.23
Options granted	259,380	$ 6.32
Options vested	(80,785)	$ 8.94
Options forfeited	(22,210)	$ 6.95
Non-vested options at September 30, 2008	710,942	$ 6.71

A summary of the options vested or expected to vest and options exercisable as of September 30, 2008 is presented below:

	Options Vested or Expected to Vest			
	Number	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
September 30, 2008	1,166,536	$ 14.69	$3,423,467	7.0 years

	Options Exercisable			
	Number	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
September 30, 2008	544,891	$ 12.74	$2,470,902	5.6 years

The total intrinsic value of options exercised was $0.1 million for both the three months ended September 30, 2008 and 2007, respectively, and $0.2 million and $1.2 million for the nine months ended September 30, 2008 and 2007, respectively. The tax benefits recognized by the Company for these exercises were less than $0.1 million for the three months ended September 30, 2008 and 2007, respectively. Tax benefits recognized by the Company were less than $0.1 million for the nine months ended September 30, 2008 and $0.4 million for the nine months ended September 30, 2007.

As of September 30, 2008, there was $1.6 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: 2008 $0.4 million; 2009 $0.8 million; 2010 $0.3 million; and 2011

$0.1 million.

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, 2007.

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 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 claim file, some estimates need to be adjusted during the life cycle of the claim file as matters continue to develop. Factors that can necessitate case 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 also include provisions for losses in excess of the current case reserve for previously reported claims and for claims that may be reopened. The IBNR reserves also include offsets for anticipated indemnity recoveries.

The following table shows the estimated liability as of September 30, 2008 for unpaid claims applicable to reported claims and to IBNR for each sub-line of business (dollars in thousands):

	Gross Case Loss and LAE Reserves	Gross IBNR Loss and LAE Reserves	Total Gross Reserves
Contract	$ 104,125	$ 198,866	$ 302,991
Commercial	53,432	52,588	106,020
Fidelity and other	5,277	10,273	15,550
Total	$ 162,834	$ 261,727	$ 424,561

Periodic actuarial analyses of the Company s loss reserves are performed. 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 of expected claim activity prepared in connection with the comprehensive review. Beginning in 2009, the Company intends to change the timing of the comprehensive review to occur in the fourth quarter using data as of September 30.

The actuarial analyses are based upon multiple projection methodologies that involve detailed statistical analysis of past claim reporting, settlement activity, and indemnification activity, as 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.

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

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

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

Changes in the claims handling process;

Potential changes in the Company s reinsurance program; and

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

Management believes that the impact of the factors listed above, and others, may not be fully quantifiable through actuarial analysis. Accordingly, management 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 actuarial analysis at December 31, 2007 and as of the most recent analysis, June 30, 2008, which was completed during the third quarter of 2008, 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, 2007	$ 472,842
Actuarial point estimate at December 31, 2007	469,589
Difference at December 31, 2007	$ 3,253
Difference as a % of actuarial point estimate	0.7%
Recorded loss reserves at June 30, 2008	$ 495,041
Actuarial point estimate at June 30, 2008	449,726
Difference at June 30, 2008	$ 45,315
Difference as a % of actuarial point estimate	10.1%
Recorded loss reserves at September 30, 2008	$ 424,561
Net Basis:	
Recorded loss reserves at December 31, 2007	$ 322,346
Actuarial point estimate at December 31, 2007	317,325
Difference at December 31, 2007	$ 5,021
Difference as a % of actuarial point estimate	1.6%
Recorded loss reserves at June 30, 2008	$ 342,745
Actuarial point estimate at June 30, 2008	298,101
Difference at June 30, 2008	$ 44,644
Difference as a % of actuarial point estimate	15.0%
Recorded loss reserves at September 30, 2008	$ 342,180

At December 31, 2007, management s recorded gross and net reserves were slightly higher than the actuarial point estimate, with the percentage difference being somewhat larger on a net basis and concentrated in the more recent accident years. Management believed that it was premature to reduce these reserves due to the inherent uncertainty associated with the more recent accident years, particularly in light of current economic conditions.

The conclusion of the actuarial analysis conducted during the third quarter of 2008 with data as of June 30, 2008 resulted in lower actuarial point estimates on both a gross and net basis. These lower estimates resulted from positive claim frequency trends. These positive trends resulted in improvements for accident years 2001 through 2006. As a result of the actuarial analysis, management recorded favorable prior year loss development of $24.9 million on a net basis during the third quarter. Although the actuarial analysis indicated greater favorable development, management believes that there is increased uncertainty associated with the more recent accident years due to the potential adverse impact of volatile economic conditions and that it is premature to reduce these reserves.

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

Casualty insurance loss reserves are subject to a significant amount of uncertainty. Given the nature of surety losses with its low frequency, high severity characteristics, this is particularly true for surety loss reserves. As a result, the range of reasonable loss reserve estimates may be broader than that associated with traditional property/casualty insurance products. While the loss reserve estimates represent the best professional judgments, arrived at after careful actuarial analysis of the available data, it is important to note that variation from the estimates is not only possible but, in fact, probable. The 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 Mack methodology and the point estimate analysis were utilized 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, the 50th and 75th percentile were selected as representing a reasonable range of reserve estimates.

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 indemnification 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 indemnification recoveries. Conversely, if the Company were to experience an unusually low number of large claims and/or an unusually high number of large indemnification 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.

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

Investments

Management believes the Company has the ability to hold all fixed income securities to maturity. However, the Company may dispose of securities prior to their scheduled maturity due to changes in interest rates, prepayments, tax and credit considerations, liquidity or regulatory capital requirements, or other similar factors. As a result, the Company 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 in stockholders equity as a separate component of accumulated other comprehensive income. Cash flows from purchases, sales and maturities are reported gross in the investing activities section of the Condensed Consolidated Statements of Cash Flows.

The amortized cost of fixed income securities is determined based on cost and the cumulative effect of amortization of premiums and accretion of discounts. 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 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, 2008 and December 31, 2007 includes intangible assets of approximately $138.8 million. This amount represents goodwill and identified intangibles with indefinite useful lives arising from the acquisition of Capsure Holdings Corp. (Capsure).

A significant amount of judgment is required in performing intangible assets impairment tests. Such tests include periodically determining or reviewing the estimated fair value of CNA Surety s reporting units. Under the relevant standard, fair value 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 value of the reporting unit over the estimated fair value of net assets would establish the implied value of intangible assets. The excess of the recorded amount of intangible assets over the implied value of intangible assets is recorded as an impairment loss.

Insurance Premiums

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

Deferred Policy Acquisitions Costs

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

Results of Operations

Financial Measures

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

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

Operating ratios are calculated using insurance results and are widely used by the insurance industry and regulators such as state departments of insurance and the National Association of Insurance Commissioners for financial regulation and as a basis of comparison among companies. The ratios discussed in the Company s MD&A are calculated using GAAP financial results and

include the net loss and loss adjustment expense ratio (loss ratio) as well as the net commissions, brokerage and other underwriting expense ratio (expense ratio) 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.

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

Comparison of CNA Surety Actual Results for the Three and Nine Months Ended September 30, 2008 and 2007

Analysis of Net Income

Net income for the three months ended September 30, 2008 was $34.3 million, or $0.78 per diluted share, compared to $28.0 million, or $0.63 per diluted share, for the same period in 2007. The increase in net income reflects higher favorable loss development on prior accident years, partially offset by lower net earned premium due to $4.2 million of additional ceded premiums for the 2007 third party excess of loss treaty and higher expenses.

Net income for the nine months ended September 30, 2008 was $81.3 million, or $1.84 per diluted share, compared to $70.6 million, or $1.60 per diluted share, for the same period in 2007. The increase in net income reflects higher net earned premium, higher net investment income and higher favorable loss development on prior accident years.

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

Results of Insurance Operations

Underwriting components for the Company for the three and nine months ended September 30, 2008 and 2007 are summarized in the following table (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Gross written premiums	$ 120,362	$ 123,549	$ 361,299	$ 367,902
Net written premiums	$ 108,805	$ 113,977	$ 333,626	$ 338,967
Net earned premiums	$ 109,696	$ 113,617	$ 320,814	$ 317,607
Net losses and loss adjustment expenses	$ 8,745	$ 23,835	$ 62,103	$ 75,632
Net commissions, brokerage and other expenses	$ 61,694	$ 59,952	$ 174,806	$ 170,870
Loss ratio	8.0%	21.0%	19.4%	23.8%
Expense ratio	56.2	52.8	54.5	53.8
Combined ratio	64.2%	73.8%	73.9%	77.6%

Premiums Written/Earned

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

Through one of its insurance subsidiaries, Western Surety Company (Western Surety), the Company assumes significant amounts of premiums primarily from affiliates. This includes 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 that is reinsured by Western Surety pursuant to reinsurance and related agreements. Because of certain regulatory restrictions that limit the Company s ability to write business on a direct basis, the Company continues to utilize the underwriting capacity available through these agreements. The Company is in full control of all aspects of the underwriting and claim management of this assumed business.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Contract	$ 78,418	$ 82,381	$ 233,766	$ 240,397
Commercial	34,331	33,361	103,192	103,048
Fidelity and other	7,613	7,807	24,341	24,457
	$ 120,362	$ 123,549	$ 361,299	$ 367,902

For the three months ended September 30, 2008, gross written premiums decreased 2.6 percent to $120.4 million compared to $123.5 million for the three months ended September 30, 2007. Contract surety gross written premiums decreased 4.8 percent to $78.4 million in the third quarter due to an overall slowdown in the construction industry. Commercial surety and fidelity and other gross written premiums increased 1.9 percent to $41.9 million due to growth in large commercial written premiums.

For the nine months ended September 30, 2008, gross written premiums decreased 1.8 percent to $361.3 million as compared to the nine-month period ended September 30, 2007. Gross written premiums for contract surety decreased 2.8 percent to $233.8 million primarily due to lower demand resulting from fewer new construction projects. Commercial surety and fidelity and other gross written premiums were flat compared to the first nine months of 2007.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Contract	$ 67,692	$ 73,824	$ 208,490	$ 214,344
Commercial	33,500	32,346	100,795	100,166
Fidelity and other	7,613	7,807	24,341	24,457
	$ 108,805	$ 113,977	$ 333,626	$ 338,967

For the quarter ended September 30, 2008, net written premiums decreased by 4.5 percent to $108.8 million from the third quarter of 2007 due to the decrease in gross written premiums and additional ceded premiums of $4.2 million related to additional losses ceded under the 2007 third party excess of loss treaty.

For the nine months ended September 30, 2008, net written premiums decreased 1.6 percent to $333.6 million, primarily due to the decrease in gross written premiums described above. Despite the additional ceded premiums under the 2007 third party excess of loss treaty in the third quarter of 2008, ceded written premiums decreased $1.3 million to $27.7 million for the first nine months of 2008 compared to the same period last year due to lower costs on the core reinsurance program.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Contract	$ 68,274	$ 72,482	$ 198,772	$ 196,424
Commercial	33,493	33,162	98,487	97,545
Fidelity and other	7,929	7,973	23,555	23,638
	$ 109,696	$ 113,617	$ 320,814	$ 317,607

For the three months ended September 30, 2008, net earned premiums decreased 3.5 percent to $109.7 million as compared to the quarter ended September 30, 2007, primarily due to the increase in ceded written premiums described above which were fully recognized as ceded earned premium in the third quarter of 2008.

For the nine months ended September 30, 2008, net earned premiums increased 1.0 percent to $320.8 million, primarily due to the decrease in ceded written premiums described above.

Net Loss Ratio

The net loss ratio was 8.0% for the three months ended September 30, 2008 compared with 21.0% for the same period in 2007. These loss ratios include revisions of prior accident year reserves, known as reserve development. Favorable prior year loss reserve development was $24.9 million, or 22.7 percentage points, in the current quarter compared to $5.0 million, or 4.4 percentage points, in the same period last year.

Excluding the impact of additional ceded premiums in the third quarter of 2008, the 2008 net loss ratio for the three months ended September 30, 2008 also reflects the impact of a four and three-tenths percentage point increase ($5.0 million) in the loss ratio for the current accident year to reflect current economic conditions. This increase was intended to raise the year to date current accident year loss ratio by one and one-half percentage points from the current accident year loss ratio selection used in the six months ended June 30, 2008.

The net loss ratio was 19.4% for the nine months ended September 30, 2008 compared with 23.8% for the same period last year. Revisions of prior accident years for the nine months ended September 30, 2008 were reductions of $25.0 million, or 7.8 percentage points, compared to $5.1 million, or 1.6 percentage points, for the nine months ended September 30, 2007.

Expense Ratio

The expense ratio was 56.2% for the three months ended September 30, 2008 as compared with 52.8% for the same period in 2007. The expense ratio was 54.5% for the nine months ended September 30, 2008 as compared with 53.8% for the same period in 2007. These ratios increased primarily due to the impact on net earned premium of the additional ceded premiums discussed above and the impact of increased accruals for incentive compensation based on strong results for the nine months ended September 30, 2008.

Investment Income and Realized Investment Gains/Losses

Net investment income was $11.8 million for the three months ended September 30, 2008, as compared with $11.3 million for the same period in 2007. This increase is due to higher overall invested assets. The annualized pre-tax yield was 4.3% and 4.6% for the three months ended September 30, 2008 and 2007, respectively. The annualized after-tax yield was 3.5% and 3.8% for the three months ended September 30, 2008 and 2007, respectively. The decrease in annualized yields was due to a decline in short-term yields and an increase in short-term investments. Net realized investment losses were $0.2 million for the quarter ended September 30, 2008, compared to net realized investment gains of $0.1 million in the same period of 2007. The net realized investment losses in the three months ended September 30, 2008 include the impairment losses on equity securities that are related to a non-qualified deferred compensation plan. Changes in the value of these investments also result in an offsetting change to the deferred compensation liability recognized in the Company s statement of income.

Net investment income was $35.3 million for the nine months ended September 30, 2008 as compared with $32.8 million for the same period in 2007. The increase is due to the impact of higher overall invested assets. The annualized pre-tax yields were 4.4% and 4.6% for the nine months ended September 30, 2008 and 2007, respectively. The annualized after-tax yields were 3.7% and 3.8% for the nine months ended September 30, 2008 and 2007, respectively. Net realized investment losses were $0.2 million for the first nine months of 2008 as compared to $0.5 million for the same period in 2007. The net realized investment losses in 2008 were primarily due to the impairment of equity securities discussed above. In 2007, the net realized investment losses were primarily due to impairment losses of $0.9 million on 13 fixed income securities during the second quarter.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Gross realized investment gains	$	$ 123	$ 11	$ 514
Gross realized investment losses	(177)	(58)	(218)	(1,000)
Net realized investment (losses) gains	$ (177)	$ 65	$ (207)	$ (486)

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 decreased by 31.6 percent for the three months ended September 30, 2008 as compared with the same period in 2007, due to lower interest rates and because the credit facility, described later in Liquidity and Capital Resources, matured on June 30, 2008 and was not replaced by the Company. Weighted average debt outstanding was $30.9 million for both the three months ended September 30, 2008 and 2007. The weighted average interest rate for the three months ended September 30, 2008 was 6.1% as compared with 8.8% for the same period in 2007.

Interest expense decreased by 24.3 percent for the nine months ended September 30, 2008 as compared with the same period in 2007. Weighted average debt outstanding was $30.9 million for both the nine months ended September 30, 2008 and 2007. The weighted average interest rate for the nine months ended September 30, 2008 was 6.6% as compared with 8.8% for the same period in 2007.

Income Taxes

The Company s income tax expense was $16.0 million and $36.0 million for the three and nine months ended September 30, 2008. The Company s income tax expense was $12.5 million and $30.6 million for the three and nine months ended September 30, 2007. The effective income tax rates for the three and nine months ended September 30, 2008 were 31.8% and 30.7%, respectively. The effective income tax rates for the three and nine months ended September 30, 2007 were 30.8% and 30.2%, respectively. The Company s effective tax rate differs from the statutory tax rate due primarily to tax-exempt investment income. Tax-exempt investment income was $6.1 million and $17.5 million for the three and nine months ended September 30, 2008, respectively. Tax-exempt investment income was $5.5 million and $15.4 million for the three and nine months ended September 30, 2007, respectively.

Exposure Management

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

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

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

Excess of Loss Reinsurance

The Company s 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.

2008 Third Party Reinsurance Compared to 2007 Third Party Reinsurance

Effective January 1, 2008, CNA Surety entered into a new excess of loss treaty (2008 Excess of Loss Treaty) with a group of third party reinsurers on terms similar to the 2007 Excess of Loss Treaty. Under the 2008 Excess of Loss Treaty, the Company s net retention per principal remained at $10 million with a 5% co-participation in the $90 million layer of third party reinsurance coverage above the Company s retention. The contract provides aggregate coverage of $185 million and includes an optional extended discovery period, for an additional premium (a percentage of the original premium based on any unexhausted aggregate limit by layer), which will provide coverage for losses discovered beyond 2008 on bonds that were in force during 2008. The contract also includes a provision for additional premiums based on losses ceded under the contract. The primary difference between the 2008 Excess of Loss Treaty and the Company s 2007 Excess of Loss Treaty is as follows. The base annual premium for the 2008 Excess of Loss Treaty is $33.3 million compared to the base annual cost of the 2007 Excess of Loss Treaty of $38.3 million before additional premium resulting from loss activity. The Company has incurred additional ceded premiums under the 2007 Excess of Loss Treaty of $8.5 million, including $4.2 million of additional ceded premiums recorded for the three and nine months ended September 30, 2008. Only the large national contractor that was excluded from the 2007 treaty remained excluded from the 2008 Excess of Loss Treaty.

Related Party Reinsurance

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

The Services and Indemnity Agreement provides the Company s insurance subsidiaries with the authority to perform various administrative, management, underwriting and claim functions in order to conduct the 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, 2008 and expires on December 31, 2008 and is annually renewable thereafter.

Through 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, 2008 and expires on December 31, 2008 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, 2008.

Through the Stop Loss Contract, the Company s insurance subsidiaries were protected from adverse loss experience on certain business underwritten after the Merger Date. The Stop Loss Contract between the insurance subsidiaries and CCC limited the insurance subsidiaries prospective net loss ratios with respect to certain accounts and lines of insured business for three full accident years following the Merger Date. In the event the insurance subsidiaries accident year net loss ratio exceeds 24% in any of the accident years 1997 through 2000 on certain insured accounts (the Loss Ratio Cap), the Stop Loss Contract requires CCC at the end of each calendar quarter following the Merger Date, to pay to the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which the Company s actual accident year net loss ratio exceeds the applicable Loss Ratio Cap, multiplied by (ii) the applicable net earned premiums. In consideration for the coverage provided by the Stop Loss Contract, the insurance subsidiaries paid to CCC an annual premium of $20,000. The CNA Surety insurance subsidiaries have paid CCC all required annual premiums. As of December 31, 2007, the net amount billed and received by the Company under the Stop Loss Contract was $42.3 million. This amount included $24.0 million held by the Company for losses covered by this contract that were incurred but not paid as of December 31, 2007. As of September 30, 2008, losses incurred under the

Stop Loss Contract were $49.6 million. This amount includes anticipated indemnification recoveries expected for subject losses. CCC has paid all amounts due under the Stop Loss Contract as of September 30, 2008, net of $2.0 million related to expected recoveries.

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 was 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, which expired on 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. In January 2007, the Company and CCC agreed by addendum to extend this contract for another twelve months. This extension, which expired on December 31, 2007, was for an additional premium of $0.5 million, which was based on the level of actual premiums written on bonds for the large national contractor. In December 2007, the Company and CCC agreed by addendum to extend this contract for another twelve months. This extension, which will expire on December 31, 2008, was for an additional premium subject to the level of actual premiums written on bonds for the large national contractor. As of both September 30, 2008 and December 31, 2007, the Company had ceded losses of $50.0 million under the terms of this contract, with unpaid ceded losses of $46.8 million.

As of September 30, 2008 and December 31, 2007, CNA Surety had an insurance receivable balance from CCC and CIC of $58.8 million and $62.9 million, respectively. At September 30, 2008, this receivable included $46.8 million of reinsurance recoverables, and $12.0 million of premiums receivable. At December 31, 2007, this receivable included $50.5 million of reinsurance recoverables and $12.4 million of premiums receivable. CNA Surety had reinsurance payables to CCC and CIC of less than $0.1 million and $0.1 million at September 30, 2008 and December 31, 2007, respectively.

Liquidity and Capital Resources

It is anticipated that the liquidity requirements of CNA Surety will be met primarily by funds generated from operations. The principal sources of operating cash flows are premiums, investment income, recoveries under reinsurance contracts and sales and maturities of investments. The primary cash flow uses are payments for claims, operating expenses, federal income taxes and debt service, as well as dividends to CNA Surety stockholders. 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, 2008, the carrying value of the Company s insurance subsidiaries invested assets was comprised of $965.5 million of fixed income securities, $78.3 million of short-term investments and $1.9 million of cash. At December 31, 2007, the carrying value of the Company s insurance subsidiaries invested assets was comprised of $963.4 million of fixed income securities, $42.2 million of short-term investments and $4.7 million of cash.

Cash flow at the parent company level is derived principally from dividend and tax sharing payments from its insurance subsidiaries, and to a lesser extent, investment income. The principal obligations at the parent company level are to service debt and pay operating expenses, including income taxes. At September 30, 2008, the parent company s invested assets consisted of $1.4 million of equity securities, $4.6 million of short-term investments and $5.8 million of cash. At December 31, 2007, the parent company s invested assets consisted of $1.8 million of equity securities, $7.3 million of short-term investments and $4.8 million of cash. At September 30, 2008 and December 31, 2007, parent company short-term investments and cash included $7.2 million and $9.8 million, respectively, of restricted cash and short-term investments primarily related to premium receipt collections ultimately due to the Company s insurance subsidiaries.

The Company s consolidated net cash flow provided by operating activities was $31.0 million for the three months ended September 30, 2008 compared to net cash flow provided by operating activities of $58.2 million for the comparable period in 2007. The decrease in net cash flow is due to the payment of $49.0 million on July 1, 2008 in settlement of a large claim that had been fully reserved as of June 30, 2008. These funds had been held in short-term investments at June 30, 2008. Upon payment of the claim, the Company billed its excess of loss reinsurers for the $25.4 million of recoverables associated with this claim. These recoverables were received during the third quarter of 2008.

Cash flows in the third quarter of 2008 also included $4.3 million of excess funds received from the trust included in the Company s Condensed Consolidated Balance Sheet as Deposit with affiliated ceding company . The trust was previously established to fund future payments pursuant to an agreement with a claimant and is more fully described in the Liquidity and Capital Resources section of Item 7., Management s Discussion and Analysis of Financial Condition and Results of Operations, in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

The Company s consolidated net cash flow provided by operating activities was $85.2 million for the nine months ended September 30, 2008 compared to net cash flow provided by operating activities of $91.3 million for the comparable period in 2007. Excluding the impact of the return of cash collateral of $7.9 million which reduced cash flows in the previous year s nine-month period, net cash flows decreased $14.0 million. This decrease was primarily driven by the same cash flows identified for the comparison of the three-month periods discussed above.

In May 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 at par value 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 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 approximately $80.0 million, consisting of annual dividend payments of $1.9 million over 26 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 junior subordinated debenture bears interest at a rate of LIBOR plus 337.5 basis points and matures in April 2034. As of September 30, 2008 and 2007, the interest rate on the junior subordinated debenture was 6.179% and 8.933%, respectively.

On June 30, 2008 the Company s credit facility matured. There was no outstanding balance under this facility (the 2005 Credit Facility) during 2008. The 2005 Credit Facility was entered into on July 27, 2005, when the Company refinanced $30.0 million in outstanding borrowings under its previous credit facility. The 2005 Credit Facility provided an aggregate of up to $50.0 million in borrowings under a revolving credit facility. In September 2006, the Company reduced the available aggregate revolving credit facility to $25.0 million in borrowings. The 2005 Credit Facility also contained certain conditions and limitations on the Company. The Company was in compliance with all covenants as of and for the three and nine months ended September 30, 2007 and for the six months ended June 30, 2008 when the 2005 Credit Facility matured.

The term of borrowings under the 2005 Credit Facility was fixed, at the Company s option, for a period of one, two, three, or six months. The interest rate was based on, among other rates, the London Interbank Offered Rate (LIBOR) plus the applicable margin. The margin, including a utilization fee, varied based on the Company s leverage ratio (debt to total capitalization) from 0.80% to 1.00%. There was no outstanding balance under the 2005 Credit Facility during the three and nine months ended September 30, 2007 and the six months ended June 30, 2008. As such, the Company incurred only the facility fee of 0.300%.

A summary of the Company s commitments as of September 30, 2008 is presented in the following table (in millions):

Contractual Obligations as of September 30, 2008	**2008**	**2009**	**2010**	**2011**	**2012**	**Thereafter**	**Total**
Debt (a)	$ 0.5	$ 1.9	$ 1.9	$ 1.9	$ 1.9	$ 71.9	$ 80.0
Operating leases	0.5	2.0	2.0	1.8	1.0		7.3
Loss and loss adjustment expense reserves	35.5	127.6	109.8	65.3	29.4	57.0	424.6
Other long-term liabilities (b)	0.3	1.3	0.9	0.8	0.5	8.2	12.0
Total	$ 36.8	$ 132.8	$ 114.6	$ 69.8	$ 32.8	$ 137.1	$ 523.9

(a) Reflects expected principal and interest payments.

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

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

The dividends that may be paid without prior regulatory approval are determined by formulas established by the applicable insurance regulations, as described above. The formulas that determine dividend capacity in the current year are dependent on, among other items, the prior year s ending statutory surplus and statutory net income. Dividend capacity for 2008 is based on statutory surplus and income at and for the year ended December 31, 2007. Without prior regulatory approval in 2008, Western Surety may pay dividends of $96.7 million to CNA Surety. CNA Surety received $3.0 million in dividends from its insurance subsidiaries and no dividends from its non-insurance subsidiaries during the first nine months of 2008. CNA Surety received $2.0 million in dividends from its insurance subsidiaries and no dividends from its non-insurance subsidiaries during the first nine months of 2007.

Combined statutory surplus totaled $530.0 million at September 30, 2008, resulting in an annualized net written premium to statutory surplus ratio of to 0.8 to 1. Insurance regulations restrict Western Surety s maximum net retention on a single surety bond to 10 percent of statutory surplus. Under the 2008 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, 2008, this regulation would limit Western Surety s largest gross risk to $138.5 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 the Internal Revenue Service. CNA Surety received $30.1 million and $28.6 million from its subsidiaries for the nine months ended September 30, 2008 and September 30, 2007, 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, 2007 through June 30, 2008, the underwriting limitations of Western Surety and Surety Bonding were $34.2 million and $0.7 million, respectively. Effective July 1, 2008 through June 30, 2009, the underwriting limitations of Western Surety and Surety Bonding are $43.5 million and $0.7 million, respectively. Through the Quota Share Treaty previously discussed, CNA Surety has access to CCC and its affiliates U.S. Department of Treasury underwriting limitations. Effective July 1, 2007 through June 30, 2008, the underwriting limitations of CCC and its affiliates utilized under the Quota Share Treaty totaled $739.9 million. Effective July 1, 2008 through June 30, 2009, the underwriting limitations of CCC and its affiliates total $783.7 million. CNA Surety management believes that the foregoing U.S. Treasury underwriting limitations are sufficient for the conduct of its business.

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

Financial Condition

Investment Portfolio

The estimated fair value and amortized cost or cost of fixed income and equity securities held by CNA Surety at September 30, 2008 and December 31, 2007, by investment category, were as follows (dollars in thousands):

September 30, 2008	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses Less Than 12 Months	Gross Unrealized Losses More Than 12 Months	Estimated Fair Value
Fixed income securities:					
U.S. Treasury securities and obligations of U.S. Government and agencies:					
U.S. Treasury	$ 17,744	$ 820	$	$	$ 18,564
U.S. Agencies	54,599	504	(9)		55,094
Collateralized mortgage obligations	30,331	395	(235)		30,491
Mortgage pass-through securities	73,648	423	(266)	(386)	73,419
Obligations of states and political subdivisions	651,811	7,027	(12,110)	(14,648)	632,080
Corporate bonds	97,033	219	(4,830)	(4,077)	88,345
Non-agency collateralized mortgage obligations	35,036		(442)	(2,096)	32,498
Other asset-backed securities:					
Second mortgages/home equity loans	8,600		(118)	(472)	8,010
Credit card receivables	17,238	1	(794)		16,445
Other	10,762	25	(263)		10,524
Total fixed income securities	996,802	9,414	(19,067)	(21,679)	965,470
Equity securities	1,405				1,405
Total	$ 998,207	$ 9,414	$ (19,067)	$ (21,679)	$ 966,875

December 31, 2007	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses Less Than 12 Months	Gross Unrealized Losses More Than 12 Months	Estimated Fair Value
Fixed income securities:					
U.S. Treasury securities and obligations of U.S. Government and agencies:					
U.S. Treasury	$ 17,790	$ 485	$	$	$ 18,275
U.S. Agencies	52,617	706		(15)	53,308
Collateralized mortgage obligations	30,086	502	(11)	(107)	30,470
Mortgage pass-through securities	54,659	401		(586)	54,474

Obligations of states and political subdivisions	625,858	15,408	(2,500)	(641)	638,125
Corporate bonds	95,714	1,493	(97)	(1,408)	95,702
Non-agency collateralized mortgage obligations	35,011	232		(699)	34,544
Other asset-backed securities:					
Second mortgages/home equity loans	9,951			(50)	9,901
Credit card receivables	17,234	451			17,685
Other	10,788	157		(75)	10,870
Total fixed income securities	949,708	19,835	(2,608)	(3,581)	963,354
Equity securities	1,683	106			1,789
Total	$ 951,391	$ 19,941	$ (2,608)	$ (3,581)	$ 965,143

31

The following table summarizes for fixed income securities in an unrealized loss position at September 30, 2008 and December 31, 2007 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, 2008		December 31, 2007	
Unrealized Loss Aging	**Estimated Fair Value**	**Gross Unrealized Loss**	**Estimated Fair Value**	**Gross Unrealized Loss**
Fixed income securities:				
Investment grade (a):				
0-6 months	$ 286,207	$ 10,841	$ 17,785	$ 175
7-12 months	99,489	8,226	112,914	2,433
13-24 months	84,473	14,648	9,984	671
Greater than 24 months	45,839	5,667	91,683	2,463
Total investment grade	516,008	39,382	232,366	5,742
Non-investment grade:				
Greater than 24 months	2,658	1,364	3,582	447
Total	$ 518,666	$ 40,746	$ 235,948	$ 6,189

(a) Investment grade is determined by the higher of the two ratings, Standard & Poor s or Moody s Investor Services, when a security has a split rating.

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 identified, the security is written down to fair value and the resulting losses are recognized in realized gains/losses in the Condensed Consolidated Statements of Income.

During the third quarter of 2008, the Company recorded other than temporary impairment losses of $0.2 million on the equity securities that are related to the Company s non-qualified deferred compensation plan. Other than temporary impairment losses for the nine months ended September 30, 2008 were also $0.2 million as no other than temporary impairments were recorded through the second quarter of 2008.

No other than temporary impairments were recorded for the three months ended September 30, 2007. During the second quarter of 2007, the Company recorded other than temporary impairment losses of $0.9 million on 13 fixed income securities of various categories of investments that were in an unrealized loss position. These impairment losses were recognized as significant interest rate changes and a revised outlook on the interest rates resulted in the Company s intention not to hold these securities to their anticipated recovery. These securities were sold during the third quarter of 2007.

As of September 30, 2008, 125 fixed income securities held by the Company were in an unrealized loss position. The Company believes that 119 of these securities are in an unrealized loss position due to general market disruptions, the relative performance and changing market views of asset classes and changes in interest rates. However, the Company believes there are no credit issues specific to these individual securities. Therefore, the Company expects these securities will recover in value at or before maturity. All of these 119 securities are investment grade. 48 of these securities were rated AA by Standard & Poor s (S&P) or Aa1, Aa2 or Aa3 by Moody s Investor Services (Moody s). 52 of these securities were rated AAA by S&P or Aaa by Moody s. Of these 119 securities, 51 were in a loss position that exceeded 5% of its book value, with the largest unrealized loss percentage being 38.8% of that security s book value resulting in an unrealized loss of $1.2 million. The largest unrealized loss was $1.5 million, which was 14.4% of that security s book value.

Of the six remaining securities that were in an unrealized loss position, one was issued by the financing subsidiary of a large domestic automaker. The security was in an unrealized loss position of 33.9% ($1.4 million) of its book value and was rated below investment grade by S&P and Moody s. One of the other securities, rated investment grade by S&P and Moody s, was issued by a large student loan provider and was in an unrealized loss position of 38.5% ($1.2 million) of its book value. Another of these securities was an asset-backed security collateralized by sub-prime home loans. This security, rated investment grade by Moody s but below investment grade by S&P, was in an unrealized loss position of 10.2% ($0.5 million) of its book value. The three remaining securities, rated investment grade by S&P and Moody s, were issued by governmental utility authorities and were in an unrealized loss position of 20.9% ($1.1 million), 25.5% ($2.8 million) and 26.8% ($1.5 million), respectively. The Company believes that the financial condition of these issuers is strong and expects that these unrealized losses will reverse at or before maturity.

The Company intends and believes it has the ability to hold these investments until the expected recovery in value, which may be at maturity.

At September 30, 2008, the Company s exposure to sub-prime home loans is limited to two asset-backed securities rated AAA and BB, respectively, by S&P that are collateralized by sub-prime home loans originated prior to 2005. One of these securities was downgraded during the first quarter of 2008 and again in the second quarter due to the downgrade of the bond insurer supporting the issue. These securities have an aggregate fair value of $8.0 million and are in an unrealized loss position of $0.6 million at September 30, 2008. In 2008, the Company has received a total of $1.4 million of repayments on these securities, including $0.6 million during the third quarter of 2008.

Municipal bonds represent approximately 60% of the Company s invested assets. Approximately 57% of these municipal bonds are insured by one of the major mono-line bond insurers. During the first quarter of 2008, one of these bond insurers was downgraded, but remained investment grade. In the second quarter, this bond insurer was downgraded again and is now rated below investment grade by both Moody s and S&P. None of the municipal bonds held by the Company and insured by this bond insurer had additional ratings downgrades during the second quarter as a result. Also during the second quarter, two of the other major bond insurers were downgraded from Aaa/AAA to Aa3/AA and Aa2/AA, respectively. As a result, 42 municipal bonds owned by the Company, with a market value of approximately $190.7 million, were downgraded during the second quarter. These holdings assumed the higher of their underlying credit rating or that of the mono-line bond insurer, which ranged from A to AAA, with the majority being AA. The Company s remaining insured municipal bonds are insured by an AAA-rated mono-line bond insurer. There were no changes to the ratings of the bond insurers during the third quarter of 2008.

The underlying ratings of all municipal holdings remain very strong and carry an average rating of AA. There are two municipal bonds with a total fair value of $9.6 million that have underlying ratings of BBB+. Both of these are insured by one of the mono-line bond insurers. The Company views the bond insurance as credit enhancement and not credit substitution and a credit review is performed on each issuer of bonds purchased. Based on the strong underlying credit quality of its insured municipal bonds, the Company believes that any impact of potential ratings downgrades or other difficulties of the mono-line bond insurers would not have a significant impact on the Company s financial position or results of operations.

At September 30, 2008, the Company s fixed income securities include eight bonds issued by the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) with a total fair value of approximately $52.6 million. Only one of these securities, a Freddie Mac bond with a book value of $1.0 million, was in an unrealized loss position (less than 1% of the security s book value). At September 30, 2008, the Fannie Mae and Freddie Mac collateralized mortgage obligations held by the Company had a total fair value of $30.5 million and a net unrealized gain of $0.2 million. Fannie Mae and Freddie Mac mortgage pass-through securities held by the Company had a total fair value of $58.1 million and a net unrealized loss of $0.3 million as of September 30, 2008.

Impact of Pending Accounting Standards

In March 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS 161), which amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133) and requires enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations and how derivative instruments and related hedge items affect an entity s financial position, financial performance and cash flows. SFAS 161 also requires the disclosure of the fair values of derivative instruments and their gains and losses in a tabular format and requires cross-referencing within the footnotes of important information about derivative instruments. In September 2008, the FASB issued Staff Position No. FAS 133 and FIN 45-1, Disclosures about Credit Derivatives and Certain Guarantees: An Amendment to FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161 (FSP SFAS 133 and FIN 45-1). FSP SFAS 133 and FIN 45-1 amends SFAS 133 to require disclosures by sellers of credit derivatives, amends FIN 45 to require additional disclosure about the current status of the risk of a guarantee and clarifies the effective date of SFAS 161.

SFAS 161 and FSP SFAS 133 and FIN 45-1 are effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Company is currently evaluating the impact that adopting SFAS 161 and FSP SFAS 133 and FIN 45-1 will have on the Company s required disclosures.

FORWARD-LOOKING STATEMENTS

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

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

Some examples of these risks and uncertainties are:

- general economic and business conditions;
- changes in financial markets such as fluctuations in interest rates, long-term periods of low interest rates, credit conditions and currency, commodity and stock prices;
- the ability of the Company s contract principals to fulfill their bonded obligations;
- the effects of corporate bankruptcies on surety bond claims, as well as on capital markets;
- changes in foreign or domestic political, social and economic conditions;
- regulatory initiatives and compliance with governmental regulations, judicial decisions, including interpretation of policy provisions, decisions regarding coverage, trends in litigation and the outcome of any litigation involving the Company and rulings and changes in tax laws and regulations;
- regulatory limitations, impositions and restrictions upon the Company, including the effects of assessments and other surcharges for guaranty funds and other mandatory pooling arrangements;
- the impact of competitive products, policies and pricing and the competitive environment in which the Company operates, including changes in the Company s books of business;

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

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

- the performance of reinsurance companies under reinsurance contracts with the Company;
- results of financing efforts, including the availability of bank credit facilities;
- changes in the Company s composition of operating segments;
- the sufficiency of the Company s loss reserves and the possibility of future increases in reserves;
- the risks and uncertainties associated with the Company s loss reserves; and,
- the possibility of further changes in the Company s ratings by ratings agencies, including the inability to access certain markets or distribution channels and the required collateralization of future payment obligations as a result of such changes and changes in rating agency policies and practices.

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

The tables below summarize the estimated effects of certain hypothetical increases and decreases in interest rates. It is assumed that the changes occur immediately and uniformly across each investment category. The hypothetical changes in market interest rates selected reflect the Company s expectations of the reasonably possible best or worst case scenarios over a one-year period. The hypothetical fair values are based upon the same prepayment assumptions that were utilized in computing fair values as of September 30, 2008. Significant variations in market interest rates could produce changes in the timing of repayments due to prepayment options available. The fair value of such instruments could be affected and therefore actual results might differ from those reflected in the following tables.

	Fair Value at September 30, 2008	Hypothetical Change in Interest Rate (bp=basis points)	Estimated Fair Value After Hypothetical Change in Interest Rate	Hypothetical Percentage Increase (Decrease) in Stockholders Equity
		(Dollars in thousands)		
U.S. Government and government agencies and authorities	$ 177,568	200 bp increase	$ 162,387	(1.4)%
		100 bp increase	170,456	(0.6)
		100 bp decrease	181,932	0.4
		200 bp decrease	183,670	0.5
States, municipalities and political subdivisions	632,080	200 bp increase	556,436	(6.8)
		100 bp increase	592,431	(3.6)
		100 bp decrease	675,842	3.9
		200 bp decrease	724,127	8.3
Corporate bonds and all other	155,822	200 bp increase	143,386	(1.1)
		100 bp increase	149,450	(0.6)
		100 bp decrease	162,569	0.6
			169,621	1.2

		200 bp decrease		
Total fixed income securities available-for-sale	$ 965,470	200 bp increase	862,209	(9.3)
		100 bp increase	912,337	(4.8)
		100 bp decrease	1,020,343	4.9
		200 bp decrease	1,077,418	10.1

	Fair Value at December 31, 2007	**Hypothetical Change in Interest Rate (bp=basis points)**	**Estimated Fair Value After Hypothetical Change in Interest Rate**	**Hypothetical Percentage Increase (Decrease) in Stockholders Equity**
		(Dollars in thousands)		
U.S. Government and government agencies and authorities	$ 156,527	200 bp increase	$ 143,016	(1.3)%
		100 bp increase	150,653	(0.6)
		100 bp decrease	160,156	0.4
		200 bp decrease	162,267	0.6
States, municipalities and political subdivisions	638,125	200 bp increase	561,138	(7.5)
		100 bp increase	598,496	(3.9)
		100 bp decrease	680,200	4.1
			725,517	8.5

		200 bp decrease		
Corporate bonds and all other	168,702	200 bp increase	153,539	(1.5)
		100 bp increase	160,869	(0.8)
		100 bp decrease	177,063	0.8
		200 bp decrease	185,960	1.7
Total fixed income securities available-for-sale	$ 963,354	200 bp increase	857,693	(10.3)
		100 bp increase	910,018	(5.3)
		100 bp decrease	1,017,419	5.3
		200 bp decrease	1,073,744	10.8

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 8 of the Condensed Consolidated Financial Statements included under Part 1, Item 1.

ITEM 1a. RISK FACTORS Information on the Company s risk factors is set forth in Item 1A Risk Factors in the Company s Annual Report on Form 10-K for the year-ended December 31, 2007.

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 25, 2008; CNA Surety Corporation Earnings Press Release issued on July 25, 2008.

ITEM 6. EXHIBITS

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

* 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.

SIGNATURES

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

CNA SURETY CORPORATION (Registrant)

/s/ John F. Welch

John F. Welch
President and Chief Executive Officer

/s/ John F. Corcoran

John F. Corcoran
Senior Vice President and Chief Financial Officer
Date: October 24, 2008

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.