CNA SURETY CORP
Form 10-Q
May 13, 2002

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

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

For the quarterly period ended March 31, 2002

OR

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

Commission file number: 1-13277

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

Delaware	36-4144905
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
CNA Plaza, Chicago, Illinois	60685
(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 X No
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APPLICABLE ONLY TO CORPORATE ISSUERS:
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

42,884,271 shares of Common Stock, $.01 par value as of May 3, 2002.

CNA SURETY CORPORATION AND SUBSIDIARIES

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INDEPENDENT ACCOUNTANTS' REPORT

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

We have reviewed the accompanying condensed consolidated balance sheet of CNA Surety Corporation and subsidiaries as of March 31, 2002, and the related condensed consolidated statements of income, stockholders' equity and cash flows for the three-month periods ended March 31, 2002 and 2001. These financial statements are the responsibility of the Corporation's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and of making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of CNA Surety Corporation and subsidiaries as of December 31, 2001, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated February 11, 2002, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2001 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Deloitte & Touche LLP
Chicago, Illinois
May 8, 2002

CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Amounts in thousands, except per share data)

	(Un Ma
ASSETS	
Invested assets and cash:	
Fixed income securities, at fair value (amortized cost: $475,028 and $464,102) ...	$
Equity securities, at fair value (cost: $56,748 and $42,614)	
Short-term investments, at cost (approximates fair value)	
Other investments, at fair value	
Cash	
Total invested assets and cash	
Deferred policy acquisition costs	
Insurance receivables:	
Premiums, including $27,219 and $29,829 from affiliates (net of allowance for	

doubtful accounts: $2,341 and $2,198)	
Reinsurance, including $55,766 and $58,027 from affiliates	
Intangible assets (net of accumulated amortization: $25,523 and $25,523)	
Property and equipment, at cost (less accumulated depreciation: $14,913 and $14,138)	
Prepaid reinsurance premiums	
Other assets	
Total assets	$ 1,

LIABILITIES	
Reserves:	
Unpaid losses and loss adjustment expenses	$
Unearned premiums	
Total reserves	
Debt	
Deferred income taxes, net	
Payable for securities purchased	
Current income taxes payable	
Reinsurance and other payables to affiliates	
Other liabilities	
Total liabilities	$
Commitments and contingencies (See Note 5)	
STOCKHOLDERS' EQUITY	
Common stock, par value $.01 per share, 100,000 shares authorized; 44,319 shares issued and 42,876 shares outstanding at March 31, 2002 and 44,229 shares issued and 42,780 shares outstanding at December 31, 2001	
Additional paid-in capital	
Retained earnings	
Accumulated other comprehensive income	
Treasury stock, at cost	
Total stockholders' equity	
Total liabilities and stockholders' equity	$ 1,

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
March 31,

	2002	2001
Revenues:		
Net earned premium	$ 67,221	$ 76,749
Net investment income	7,106	7,735
Net realized investment losses	(278)	(29)
Total revenues	74,049	84,455
Expenses:		
Net losses and loss adjustment expenses	16,647	16,086
Net commissions, brokerage and other underwriting	41,552	46,837
Interest expense	458	1,588
Amortization of intangible assets	--	1,524
Total expenses	58,657	66,035
Income before income taxes	15,392	18,420
Income taxes	4,835	6,476
Net income	$ 10,557	$ 11,944
Earnings per share	$ 0.25	$ 0.28
Earnings per share, assuming dilution	$ 0.25	$ 0.28
Weighted average shares outstanding	42,845	42,713
Weighted average shares outstanding, assuming dilution	43,025	42,917

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
Balance, December 31, 2000	42,702	$ 441	$ 253,497
Comprehensive income:			
Net income	--	--	--
Other comprehensive income:			
Change in unrealized gains on securities (after incometaxes), net of reclassification adjustment of $209	--	--	--
Total comprehensive income			

Stock options exercised and other	23	1	161
Dividends paid to stockholders	--	--	--
Balance, March 31, 2001	42,725	$ 442	$ 253,658
Balance, December 31, 2001	42,780	$ 442	$ 254,133
Comprehensive income:			
Net income	--	--	--
Other comprehensive income:			
Change in unrealized losses on securities (after income taxes), net of reclassification adjustment of $90	--	--	--
Total comprehensive income			
Issuance of treasury stock to employee stock purchase program			6
Stock options exercised and other	96	1	942
Dividends paid to stockholders	--	--	--
Balance, March 31, 2002	42,876	$ 443	$ 255,081

	Accumulated Other Comprehensive Income (Loss)	Treasury Stock (at cost)	Tota Stockhol Equi
Balance, December 31, 2000	$ 267	$(15,481)	$374,
Comprehensive income:			
Net income	--	--	11,
Other comprehensive income:			
Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of $209	946	--	
Total comprehensive income			
Stock options exercised and other	--	--	
Dividends paid to stockholders	--	--	(3,
Balance, March 31, 2001	$ 1,213	$(15,481)	$ 383,
Balance, December 31, 2001	$ 278	$(15,553)	$388,
Comprehensive income:			
Net income	--	--	10,
Other comprehensive income:			
Change in unrealized losses on securities (after income taxes), net of reclassification adjustment of $90	(1,652)	--	(1,
Total comprehensive income			

Issuance of treasury stock to employee stock purchase program		52	
Stock options exercised and other	--	--	
Dividends paid to stockholders	--	--	(6,
Balance, March 31, 2002	$ (1,374)	$(15,501)	$ 391,

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)

	Three Mont March 2002
OPERATING ACTIVITIES:	
Net income	$ 10,557
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	977
Accretion of bond discount, net	195
Net realized investment losses	278
Changes in:	
Insurance receivables	4,808
Reserve for unearned premiums	892
Reserve for unpaid losses and loss adjustment expenses	(3,586)
Deferred policy acquisition costs	(3,337)
Deferred income taxes, net	1,433
Reinsurance and other payables to affiliates	1,300
Prepaid reinsurance premiums	(3,720)
Other assets and liabilities	(3,789)
Net cash provided by operating activities	6,008
INVESTING ACTIVITIES:	
Fixed income securities:	
Purchases	(63,399)
Maturities	30,008
Sales	22,121
Purchases of equity securities	(14,829)
Proceeds from the sale of equity securities	557
Changes in short-term investments	26,304
Purchases of property and equipment	(1,491)
Changes in receivables/payables for securities sold/purchased	(4,290)
Other, net	(33)
Net cash provided by (used in) investing activities	(5,052)

FINANCING ACTIVITIES:	
Principal payments on long-term debt	--
Dividends to stockholders	--
Employee stock option exercises	824
Issuance of treasury stock to employee stock purchase plan	57
Net cash provided by (used in) financing activities	881
Increase (decrease) in cash	1,837
Cash at beginning of period	13,159
Cash at end of period	$ 14,996
Supplemental Disclosure of Cash Flow Information:	
Cash paid during the period for:	
Interest	$ 793
Income taxes	$ --

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

CNA SURETY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2002
(Unaudited)

1. Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of CNA Surety Corporation and all majority-owned subsidiaries.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ("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 2001 Annual Report to Shareholders. Certain financial information that is normally included in annual financial statements prepared in accordance with GAAP, is not required for interim reporting and has been condensed or omitted. The accompanying unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all adjustments necessary for a fair presentation of the interim financial statements. All such adjustments are of a normal and recurring nature. The financial results for interim periods may not be indicative of financial results for a full year. Certain reclassifications have been made to the 2001 Financial Statements to conform with the presentation in the 2002 Condensed Consolidated Financial Statements.

Accounting Changes

In June 2001, the FASB issued SFAS No. 141 and No. 142 entitled "Business Combinations" ("SFAS No. 141") and "Goodwill and Other Intangible Assets" ("SFAS No. 142"), respectively. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations subsequent to June 30, 2001 and specifies criteria for recognizing intangible assets acquired in a business combination. The Company will adopt this standard for any future business combinations. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually. Any impairment loss for the excess of the carrying amount of an intangible asset over its fair value would be recognized as a charge to operations. Intangible assets with definite useful lives will continue to be amortized over their respective estimated useful lives. The Company has adopted the provisions of Statement No. 142 effective January 1, 2002. In accordance with the transition guidance provided in SFAS No. 142, the Company has completed its initial impairment test related to other acquired intangibles and does not anticipate any asset impairment to be recorded for these intangibles. The Company plans to complete its goodwill-related impairment tests by June 30, 2002, with any resulting impairment recorded as a cumulative effect of a change in accounting principle as of January 1, 2002. The adoption of this standard eliminated the Company's amortization of goodwill and intangibles as of December 31, 2001 and therefore, increased the Company's reported net income by $1.4 million, or 3 cents per share, as compared to the prior year quarter. If the provisions of this standard were applied to prior periods, net income for the first three months of 2001 would have been $13.4 million, or $0.31 per

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share.

In October 2001, the FASB issued SFAS No. 144 entitled "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"). SFAS No. 144 addresses accounting and reporting for the impairment or disposal of long-lived assets. This statement supersedes FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." The provisions of this statement were effective for CNA Surety beginning January 1, 2002. The initial adoption of this standard had no impact on the Company's financial position or results of operations.

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2. Investments

The estimated fair value and amortized cost of fixed income and equity securities held by CNA Surety at March 31, 2002 and December 31, 2001, by investment category, were as follows (dollars in thousands):

March 31, 2002	Amortized Cost or Cost	Gross Unrealized Gains	G Un

Fixed income securities:			
U.S. Treasury securities and obligations of			
U.S. Government and agencies:			
U.S. Treasury	$ 14,822	$ 270	$
U.S. Agencies	58,793	1,680	
Collateralized mortgage obligations	336	4	
Mortgage pass-through securities	25,946	130	
Obligations of states and political subdivisions ..	258,916	4,767	
Corporate bonds	72,802	1,182	
Non-agency collateralized mortgage obligations	12,170	105	
Other asset-backed securities:			
Second mortgages/home equity loans	10,669	303	
Credit card receivables	10,000	254	
Manufactured housing	7,204	395	
Other	1,014	91	
Redeemable preferred stock	2,356	334	
Total fixed income securities	475,028	9,515	
Equity securities	56,748	546	
Total	$531,776	$10,061	$

December 31, 2001	Amortized Cost or Cost	Gross Unrealized Gains	Gross Un
Fixed income securities:			
U.S. Treasury securities and obligations of			
U.S. Government and agencies:			
U.S. Treasury	$ 24,751	$ 561	$
U.S. Agencies	67,539	2,119	
Collateralized mortgage obligations	411	4	
Mortgage pass-through securities	22,165	231	
Obligations of states and political subdivisions ..	217,757	5,029	
Corporate bonds	71,029	2,007	
Non-agency collateralized mortgage obligations	12,898	132	
Other asset-backed securities:			
Second mortgages/home equity loans	15,784	537	
Credit card receivables	10,000	327	
Manufactured housing	7,314	342	
Other	1,019	108	
Redeemable preferred stock	13,435	122	
Total fixed income securities	464,102	11,519	
Equity securities	42,614	2,620	
Total	$506,716	$ 14,139	$

3. Reinsurance

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

	Three Months Ended March 31,			
	2002		2001	
	Written	Earned	Written	Earned
Direct	$ 36,772	$ 31,713	$ 32,657	$ 27,620
Assumed	45,342	49,541	42,827	51,622
Ceded	(17,721)	(14,033)	(2,857)	(2,493)
	$ 64,393	$ 67,221	$ 72,627	$ 76,749

Assumed premiums primarily includes all surety business written or renewed, net of reinsurance, by CCC and CIC, and their affiliates, after the Merger Date that is reinsured by Western Surety pursuant to intercompany reinsurance and related agreements.

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

	Three Months Ended March 31,			
	2002		2001	
	$	Ratio	$	Ratio
Gross losses and loss adjustment expenses	$ 18,064	22.2%	$ 25,062	31.6%
Ceded amounts	(1,417)	10.1	(8,976)	360.0
Net losses and loss adjustment expenses	$ 16,647	24.8%	$ 16,086	21.0%

The Company's ceded reinsurance program changed significantly in 2002 as compared to 2001. As a result, ceded written premiums increased in the first quarter of 2002 as compared to the same quarter in 2001. Ceded written premiums increased $14.9 million to $17.7 million for the three months ended March 31, 2002. The increase in ceded written premiums included $7.5 million for the Company's new $40 million excess of $20 million per principal excess of loss coverage and $8.5 million for the purchase of extended discovery coverage on the Company's $55 million excess of $5 million per principal excess of loss coverage that was in place for 2001.

The material differences between the new excess of loss reinsurance program and the Company's 2001 program are as follows. The annual aggregate coverage decreases from $115 million in 2001 to $100 million in 2002 with a sub-limit of

$60 million for large commercial accounts. The minimum annual premium for the 2002 excess of loss treaty is $30.0 million compared to $17.2 million of reinsurance premiums paid in 2001. The 2002 excess of loss treaty provides the Company with coverage on a per principal basis of 90% of $40 million excess of $20 million retained by the Company. The higher net retention per principal together with other changes in reinsurance coverage associated with the 2002 excess of loss reinsurance contract and the extended discovery and related provisions of the excess of loss reinsurance contract in place for 2001 may increase the variability of the Company's future results of operations and cash flows.

4. Reserves for Losses and Loss Adjustment Expenses

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

	Three Months Ended March 31,	
	2002	2001
Reserves at beginning of period:		
Gross	$ 315,811	$ 204,457
Ceded reinsurance	166,318	70,159
Net reserves at beginning of period	149,493	134,298
Net incurred loss and loss adjustment expenses:		
Provision for insured events of current period	16,665	16,380
Increase (decrease) in provision for insured events of prior periods	(18)	(294)
Total net incurred	16,647	16,086
Net payments attributable to:		
Current period events	1,917	5
Prior period events	6,041	15,016
Total net payments	7,958	15,021
Net reserves at end of period	158,182	135,363
Ceded reinsurance at end of period	154,043	76,651
Gross reserves at end of period	$ 312,225	$ 212,014

5. Legal Proceedings

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

CNA SURETY CORPORATION AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

The following is a discussion and analysis of CNA Surety Corporation ("CNA Surety" or the "Company") and its insurance subsidiaries' operating results, liquidity and capital resources, and financial condition. This discussion should be read in conjunction with the Consolidated Financial Statements of CNA Surety and notes thereto. 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 deferred acquisition costs, reinsurance and reserves for unpaid losses and loss adjustment expenses. The Company's accounting policies related to reserves for unpaid losses and loss adjustment expenses and related estimates of reinsurance recoverables, are particularly critical to an assessment of the Company's financial results. These areas are highly subjective and require management's most complex judgments because of the need to make estimates about the effects of matters that are inherently uncertain. For these reasons, disclosure on these topics is contained in Item 1. Business of the Company's 2001 Annual Report on Form 10-K as well as in the Management's Discussion and Analysis of Financial Condition and Results of Operations and Consolidated Financial Statements and notes thereto within the 2001 Annual Report to Shareholders. Refer to the 2001 Annual Report to Shareholders Note 1, Significant Accounting Policies, and Notes 7 and 8, Reinsurance and Reserves for Losses and Loss Adjustment Expenses, respectively, for further discussion.

Formation of CNA Surety 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") and Universal Surety of America ("USA"), into CNA Surety Corporation ("CNA Surety" or the "Company"). CNAF, through its operating subsidiaries, writes multiple lines of property and casualty insurance, including surety business that is reinsured by Western Surety. CNAF owns approximately 64% of the outstanding common stock of CNA Surety. Loews Corporation owns approximately 89% of the outstanding common stock of CNAF. The principal operating subsidiaries of CNAF that wrote the surety line of business for their own account prior to the Merger were Continental Casualty Company and its property and casualty affiliates (collectively, "CCC") and The Continental Insurance Company and its property and casualty affiliates (collectively, "CIC"). CIC was acquired by CNAF on May 10, 1995. The combined surety operations of CCC and CIC are referred to herein as CCC Surety Operations.

Pursuant to a reorganization agreement, CCC Surety Operations and Capsure merged their respective operations at the close of business on September 30, 1997 ("Merger Date"). Through reinsurance agreements, CCC and CIC ceded to Western Surety all of their net unearned premiums and loss and loss adjustment expense reserves, as of the Merger Date, and will cede to Western Surety all surety business written or renewed by CCC and CIC for a period of five years thereafter. Further, CCC and CIC have agreed to assume the obligation for any adverse development on recorded reserves for CCC Surety Operations as of the Merger Date, to limit the loss ratio on certain defined business written by CNA Surety through December 31, 2000 and to provide certain additional excess of loss reinsurance.

Business

CNA Surety's insurance subsidiaries write surety and fidelity bonds in all 50 states through a combined network of approximately 35,000 independent agencies. CNA Surety's principal insurance subsidiaries are Western Surety and USA. The insurance subsidiaries write, on a direct basis or as business assumed from CCC and CIC, small fidelity and non-contract surety bonds, referred to as commercial bonds; small, medium and large contract bonds; and errors and omissions ("E&O") liability insurance. Western Surety is a licensed insurer in all 50 states, the District of Columbia and Puerto Rico. USA is licensed in 44 states and the District of Columbia. Western Surety's affiliated company, Surety Bonding Company of America ("SBCA"), is licensed in 28 states and the District of Columbia.

"Safe Harbor" Statement under the Private Securities Litigation Reform Act of 1995

The statements which are not historical facts contained in this Form 10-Q are forward-looking statements that involve risks and uncertainties, including, but not limited to, product and policy demand and market response risks, the effect of economic conditions, the impact of competitive products, policies and pricing, product and policy development, regulatory changes and conditions, rating agency policies and practices, development of claims and the effect on loss reserves, the performance of reinsurance companies under reinsurance contracts with the Company, investment portfolio developments and reaction to market conditions, the results of financing efforts, the actual closing of contemplated transactions and agreements, the effect of the Company's accounting policies, and other risks detailed in the Company's Securities and Exchange Commission filings. No assurance can be given that the actual results of operations and financial condition will conform to the forward-looking statements contained herein.

Results of Operations

CNA Surety Results for Three Months Ended March 31, 2002 and 2001

The components of income for the Company for the three months ended March 31, 2002 and 2001 are summarized as follows (dollars in thousands):

	Three Months Ended March 31,	
	2002	2001
Total revenues	$ 74,049	$ 84,455
Underwriting income	$ 9,022	$ 13,826
Net investment income	7,106	7,735
Net realized investment losses	(278)	(29)
Interest expense	458	1,588
Amortization of intangible assets	--	1,524
Income before income taxes	15,392	18,420
Income taxes	4,835	6,476

Net income	$ 10,557	$ 11,944
Net income per share	$ 0.25	$ 0.28

Insurance Underwriting

Underwriting results for the Company for the three months ended March 31, 2002 and 2001 are summarized in the following table (dollars in thousands):

	Three Months Ended March 31, 2002	2001
Gross written premiums	$82,114	$75,484
Net written premiums	$64,393	$72,627
Net earned premiums	$67,221	$76,749
Net losses and loss adjustment expenses	16,647	16,086
Net commissions, brokerage and other	41,552	46,837
Underwriting income	$ 9,022	$13,826
Loss ratio	24.8%	21.0%
Expense ratio	61.8	61.0
Combined ratio	86.6%	82.0%

Premiums Written

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

Gross written premiums are shown in the table below (dollars in thousands):

	Three Months Ended March 31, 2002	2001

Contract	$39,380	$38,332
Commercial	35,088	28,991
Fidelity and other	7,646	8,161
	$82,114	$75,484

Gross written premiums increased 8.8%, or $6.6 million, for the three months ended March 31, 2002 over the comparable period in 2001. Commercial surety accounted for most of this increase with growth of 21.0%, or $6.1 million, in gross written premiums as compared to 2001. In the first quarter of 2002, the Company experienced continued volume growth of small commercial products along with improving rates on large commercial exposures. Contract surety increased 2.7%, or $1.0 million, for the three months ended March 31, 2002 reflecting continued strength in public construction spending. Fidelity and other products decreased 6.3% to $7.6 million for the three months ended March 31, 2002 as compared to the same period in 2001 due primarily to the discontinuance of the Company's agents' E&O business.

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Net written premiums are shown in the table below (dollars in thousands):

	Three Months Ended March 31, 2002	2001
Contract	$31,235	$35,767
Commercial	25,849	28,699
Fidelity and other	7,309	8,161
	$64,393	$72,627

For the three months ended March 31, 2002, net written premiums decreased 11.3% to $64.4 million as compared to the same period in 2001, reflecting the effects of higher reinsurance costs. Ceded written premiums increased $14.9 million to $17.7 million for the three months ended March 31, 2002. Ceded written premiums in the current quarter include $7.5 million for the Company's new $40 million excess of $20 million per principal excess of loss coverage and $8.5 million for the purchase of extended discovery coverage on our $55 million excess of $5 million per principal excess of loss coverage that was in place for 2001. Net written premiums for contract surety business decreased 12.7% to $31.2 million. Net written premiums for commercial surety decreased 9.9% to $25.8 million for the first three months in 2002. The fidelity and other products decreased 10.4% to $7.3 million, for the first three months in 2002 as compared to the same period in 2001.

The material differences between the new excess of loss reinsurance program and the Company's 2001 program are as follows. The annual aggregate coverage decreases from $115 million in 2001 to $100 million in 2002 with a sub-limit of $60 million for large commercial accounts. The minimum annual premium for the 2002 excess of loss treaty is $30.0 million compared to $17.2 million of reinsurance premiums paid in 2001. The 2002 excess of loss treaty provides the Company with coverage on a per principal basis of 90% of $40 million excess of $20 million retained by the Company. The higher net retention per principal together with other changes in reinsurance coverage associated with the 2002 excess of loss reinsurance contract and the extended discovery and related provisions of the excess of loss reinsurance contract in place for 2001 may increase the variability of the Company's future results of operations and cash flows.

Underwriting Income

Underwriting income decreased 34.8% to $9.0 million for the three months ended March 31, 2002 compared to $13.8 million for the same period in 2001. This decrease is primarily due to the impact of increased reinsurance costs on net earned premium.

Net Loss Ratio

The net loss ratios for the three months ended March 31, 2002 and 2001 were 24.8% and 21.0%, respectively. The 2001 loss ratios included $0.3 million of net favorable loss reserve development. Excluding the impact of net favorable loss reserve development, the loss ratios would have been 24.8% and 21.4% for the period ended March 31, 2002 and March 31, 2001, respectively. The increase in the adjusted loss ratio in 2002 relates primarily to estimated impact of the Company's $15 million higher per principal net retention on the Company's net loss ratio. The Company is using an initial 2002 accident year net loss ratio of 30.0 percent for the medium to large commercial and contract branch business compared to 22.5 percent when the per principal retention was $5 million. This business represents about 61% of the Company's gross premiums.

Expense Ratio

The expense ratio increased to 61.8% for the three months ended March 31, 2002 compared to 61.0% for the same period in 2001. The increase in the expense ratio for the three months ended March 31, 2002 primarily reflects the impact of higher reinsurance costs on net earned premiums. Net earned premiums declined 12.4% and operating expenses decreased at a lower rate of 11.2%, reflecting the Company's acquisition and operating cost reduction efforts.

Investment Income

For the three months ended March 31, 2002, net investment income was $7.1 million compared to net investment income for the three months ended March 31, 2001 of $7.7 million. The decrease in investment income primarily reflects the impact of lower investment yields. The annualized pretax yields for the Company's equity and fixed income portfolio were 5.1% and 5.7% for the three months ended March 31, 2002 and 2001, respectively. The annualized after-tax yields for the Company's equity and fixed income portfolio were 3.9% and 4.2% for the three months ended March 31, 2002 and 2001.

Net realized investment losses were approximately $278,000 for the three months ended March 31, 2002 compared to approximately $29,000 of net realized investment losses for the same period in 2001.

Analysis of Other Operations

As of January 1, 2002, the Company adopted SFAS No. 142 which requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually. The periodic amortization of goodwill and intangibles ceased as of December 31, 2001. Amortization expense was $1.5 million for the three months ended March 31, 2001.

The Company plans to complete its goodwill-related impairment tests by June 30, 2002, with any resulting impairment recorded as a cumulative effect of a change in accounting principle as of January 1, 2002. Any future impairment loss for the excess of the carrying amount of an intangible asset over its fair value would be recognized as a charge to operations. Intangible assets primarily represent goodwill and identified intangibles arising from the acquisition of Capsure.

Interest expense for the three months ended March 31, 2002 decreased $1.1 million, or 71.2%, as compared to the first quarter in 2001, primarily due to lower outstanding debt levels and lower interest rates. Average debt outstanding was $76.2 million for the first quarter of 2002 compared to $100.9 million in the first quarter of 2001. The weighted average interest rate for the three months ended March 31, 2001 was 2.2% compared to 6.1% for the same period in 2001.

Income Taxes

Income tax expense was $4.8 million and $6.5 million and the effective income tax rates were 31.4% and 35.2% for the three months ended March 31, 2002 and 2001, respectively. This decrease in the estimated effective tax rate in first quarter 2002 primarily relates to the adoption of SFAS No. 142 which ended the periodic amortization the Company's goodwill and intangibles.

Liquidity and Capital Resources

It is anticipated that the liquidity requirements of CNA Surety will be met primarily by funds generated from operations. The principal sources of operating cash flows are premiums, investment income, and

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sales and maturities of investments. CNA Surety also may generate funds from additional borrowings under the credit facility described below. The primary cash flow uses are payments for claims, operating expenses, federal income taxes, debt service for the credit facility, 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 March 31, 2002, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of $474.0 million of fixed income securities, $50.7 million of equity securities, $2.4 million of short-term investments, $5.3 million of other investments and $10.1 million of cash. At December 31, 2001, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of $466.6 million of fixed income securities, $35.8 million of equity securities, $38.9 million of short-term investments, $5.3 million of other investments and $0.8 million of cash.

Cash flow at the parent company level is derived principally from dividend and tax sharing payments from its insurance subsidiaries. The principal obligations at the parent company level are to service debt, pay operating expenses, including income taxes, and pay dividends to stockholders. At March 31, 2002, the parent company's invested assets consisted of $5.5 million of fixed income securities, $24.9 million of short-term investments and $4.9 million of cash. At December 31, 2001, the parent company's invested assets consisted of $5.2 million of fixed income securities, $14.7 million of short-term investments and $2.4 million of cash. As of March 31, 2002 and December 31, 2001, parent company short-term investments and cash included $4.5 million and $13.8 million, respectively, of restricted cash 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 $6.0 million for the three months ended March 31, 2002 and $10.0 million for the comparable period in 2001. The decrease in net cash flow provided by operating activities primarily relates to an increase in prepaid reinsurance premiums, primarily a payment of $8.5 million to purchase extended discovery coverage on the Company's $55 million excess of $5 million per principal excess of loss coverage that was in place for 2001.

CNA Surety's bank borrowings are under a five-year unsecured revolving credit facility (the "Credit Facility") that provides for borrowings of up to $130 million. As of March 31, 2001, the Company has unused capacity under the revolver of approximately $55 million.

The interest rate on borrowings under the Credit Facility may be fixed, at CNA Surety's option, for a period of one, two, three, or six months and is based on, among other rates, the London Interbank Offered Rate ("LIBOR"), plus the applicable margin. The margin, including the facility fee, was 0.30% at March 31, 2002 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 0.25% to 0.40%. As of March 31, 2002, the weighted average interest rate was 2.1% on the $75 million of outstanding borrowings. As of December 31, 2001, the weighted average interest rate was 2.5% on the $75.0 million of outstanding borrowings.

The Credit Facility contains, among other conditions, limitations on CNA Surety with respect to the incurrence of additional indebtedness and requires the maintenance of certain financial ratios. As of March 31, 2002, the Company was in compliance with all restrictions and covenants contained in the Credit Facility agreement. The Credit Facility provides for the payment of all outstanding principal

balances by September 30, 2002 with no required principal payments prior to such time. Principal prepayments, if any, and interest payments are expected to be funded primarily through dividends from CNA Surety's insurance subsidiaries.

In 1999 CNA Surety acquired certain assets of Clark Bonding Company, Inc., a Charlotte, North Carolina, insurance agency and brokerage doing business as The Bond Exchange for $5.9 million. As part of this acquisition, the Company incurred an additional $1.9 million of debt in the form of a promissory note. The promissory note matures on July 27, 2004 and has an interest rate of 5.0%. The balance of this promissory note at March 31, 2002 was $1.2 million.

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

The dividends that may be paid without prior regulatory approval are determined by formulas established by the applicable insurance regulations, as described above. The formulas that determine dividend capacity in the current year are dependent on, among other items, the prior year's ending statutory surplus and statutory net income. Dividend capacity for 2002 is based on statutory surplus and income at and for the year ended December 31, 2001. Without prior regulatory approval in 2002, CNA Surety's insurance subsidiaries may pay stockholder dividends of $51.5 million in the aggregate. CNA Surety received $12.0 million and $20.0 million in dividends from its insurance subsidiaries during the first three months of 2002 and 2001, respectively.

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 as estimated tax payments would be required by the Internal Revenue Service ("IRS"). CNA Surety did not receive any tax sharing payments from its subsidiaries for the three months ended March 31, 2002 and received $0.3 million for the same period in 2001.

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.

CNA SURETY CORPORATION AND SUBSIDIARIES

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings - None.

ITEM 2. Changes in the Rights of the Company's Security Holders - None.

ITEM 3. Defaults Upon Senior Securities - None.

ITEM 4. Submission of Matters to a Vote of Security Holders - None.

ITEM 5. Other Information - None.

ITEM 6. Exhibits and Reports on Form 8-K:

(a) Exhibits: - None.

(b) Reports on Form 8-K:
February 15, 2002; CNA Surety Corporation Press Release issued on February 11, 2002.

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 S. Heneghan

John S. Heneghan
Vice President and Chief Financial Officer

Date: May 13, 2002