CNA SURETY CORP
Form 10-Q
August 12, 2003

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 JUNE 30, 2003

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 [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes [X] No [ ]

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

42,967,383 shares of Common Stock, $.01 par value as of August 4, 2003.

CNA SURETY CORPORATION AND SUBSIDIARIES

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ITEM 1. FINANCIAL STATEMENTS

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 June 30, 2003, and the related condensed consolidated statements of income, stockholders' equity and cash flows for the three- and six- month periods ended June 30, 2003 and 2002. These interim 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, 2002, 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 10, 2003, we expressed an unqualified opinion on those consolidated financial statements and included an explanatory paragraph relating to the Company's change in accounting for goodwill and indefinite-lived intangible assets in 2002. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2002 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
August 4, 2003

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

	(Unaudit June 3 2003
ASSETS	
Invested assets and cash:	
Fixed income securities, at fair value (amortized cost: $510,383 and $539,364)	$ 553,
Equity securities, at fair value (cost: $983 and $852)	
Short-term investments, at cost (approximates fair value)	58,
Other investments, at fair value	1,
Cash	7,
Total invested assets and cash	621,
Deferred policy acquisition costs	104,
Insurance receivables:	
Premiums, including $28,690 and $34,097 from affiliates (net of allowance for doubtful accounts: $1,582 and $1,365)	46,
Reinsurance, including $36,860 and $15,401 from affiliates	133,
Intangible assets (net of accumulated amortization: $25,523 and $25,523)	143,
Property and equipment, at cost (less accumulated depreciation: $17,482	

and $16,047)	16,
Prepaid reinsurance premiums	10,
Receivable for securities sold	3,
Other assets	8,
Total assets	$ 1,089,
LIABILITIES	
Reserves:	
Unpaid losses and loss adjustment expenses	$ 277,
Unearned premiums	228,
Total reserves	505,
Debt	55,
Deferred income taxes, net	36,
Current income taxes payable	5,
Reinsurance and other payables to affiliates	7,
Other liabilities	32,
Total liabilities	$ 642,
Commitments and contingencies (See Note 6)	
STOCKHOLDERS' EQUITY	
Common stock, par value $.01 per share, 100,000 shares authorized; 44,388 shares issued and 42,959 shares outstanding at June 30, 2003 and 44,386 shares issued and 42,947 shares outstanding at December 31, 2002	
Additional paid-in capital	255,
Retained earnings	178,
Accumulated other comprehensive income	28,
Treasury stock, at cost	(15,
Total stockholders' equity	447,
Total liabilities and stockholders' equity	$ 1,089,

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

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

	Three Months Ended June 30,		Six
	2003	2002	200
Revenues:			

Net earned premium	$ 74,658	$ 75,742	$143,
Net investment income	6,652	7,121	13,
Net realized investment gains	1,098	1,601	1,
Total revenues	82,408	84,464	158,
Expenses:			
Net losses and loss adjustment expenses	20,235	19,606	38,
Net commissions, brokerage and other underwriting expenses	47,940	45,594	92,
Interest expense	455	445	
Total expenses	68,630	65,645	131,
Income before income taxes	13,778	18,819	26,
Income taxes	3,517	5,917	7,
Net income	$ 10,261	$ 12,902	$ 19,
Earnings per share	$ 0.24	$ 0.30	$ 0
Earnings per share, assuming dilution	$ 0.24	$ 0.30	$ 0
Weighted average shares outstanding	42,959	42,900	42,
Weighted average shares outstanding, assuming dilution	42,963	43,066	42,

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
Balance, December 31, 2001	42,780	$ 442
Comprehensive income:		
Net income	--	--
Other comprehensive income:		
Change in unrealized losses on securities (after income taxes), net of reclassification adjustment of $428	--	--
Total comprehensive income		

Issuance of treasury stock to employee stock purchase program	5	
Stock options exercised and other	130	2
Dividends paid to stockholders	--	--
Balance, June 30, 2002	42,915	$ 444
Balance, December 31, 2002	42,947	$ 444
Comprehensive income:		
Net income	--	--
Other comprehensive income:		
Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of $(1,634)	--	--
Total comprehensive income		
Issuance of treasury stock to employee stock purchase program	9	--
Stock options exercised and other	3	--
Balance, June 30, 2003	42,959	$ 444

	Retained Earnings	Accumulated Other Comprehensi Income (Los
Balance, December 31, 2001	$ 149,128	$ 278
Comprehensive income:		
Net income	23,459	--
Other comprehensive income:		
Change in unrealized losses on securities (after income taxes), net of reclassification adjustment of $428	--	5,888
Total comprehensive income		
Issuance of treasury stock to employee stock purchase program		
Stock options exercised and other	--	--
Dividends paid to stockholders	(12,869)	--
Balance, June 30, 2002	$ 159,718	$ 6,166
Balance, December 31, 2002	$ 158,515	$ 19,861
Comprehensive income:		
Net income	19,828	--
Other comprehensive income:		
Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of $(1,634)	--	8,148
Total comprehensive income		
Issuance of treasury stock to employee stock purchase program		
Stock options exercised and other	1	--
Balance, June 30, 2003	$ 178,344	$ 28,009

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)

	Six
	2003
OPERATING ACTIVITIES:	
Net income	$ 19,82
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	2,09
Accretion of bond discount, net	91
Net realized investment (gains) losses	(1,82
Changes in:	
Insurance receivables	(7,48
Reserve for unearned premiums	12,20
Reserve for unpaid losses and loss adjustment expenses	(26,22
Deferred policy acquisition costs	(8,15
Deferred income taxes, net	1,50
Reinsurance and other payables to affiliates	(15,97
Prepaid reinsurance premiums	2,37
Other assets and liabilities	14
Net cash (used in) provided by operating activities	(20,61
INVESTING ACTIVITIES:	
Fixed income securities:	
Purchases	(38,35
Maturities	15,37
Sales	53,32
Purchases of equity securities	(22
Proceeds from the sale of equity securities	8
Changes in short-term investments	(7,77
Purchases of property and equipment	(1,10
Changes in receivables/payables for securities sold/purchased	(3,03
Other, net	8
Net cash provided by (used in) investing activities	18,36
FINANCING ACTIVITIES:	
Principal payments on debt	(5,00
Dividends to stockholders	-
Employee stock option exercises	
Issuance of treasury stock to employee stock purchase plan	6

Net cash used in financing activities	(4,93
Increase (decrease) in cash	(7,18
Cash at beginning of period	14,97
Cash at end of period	$ 7,79
Supplemental Disclosure of Cash Flow Information:	
Cash paid during the period for:	
Interest	$ 55
Income taxes	$ 5,00

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

CNA SURETY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2003
(UNAUDITED)

1. SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include the accounts of CNA Surety Corporation ("CNA Surety" or the "Company") 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 2002 Annual Report to Shareholders. Certain financial information that is included in annual financial statements prepared in accordance with GAAP, is not required for interim reporting and has been condensed or omitted. The accompanying unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all adjustments necessary for a fair presentation of the interim financial statements. All such adjustments are of a normal and recurring nature. The financial results for interim periods may not be indicative of financial results for a full year. Certain reclassifications have been made to the 2002 Financial Statements to conform with the presentation in the 2003 Condensed Consolidated Financial Statements.

Accounting Changes

In August 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 143 entitled "Accounting for Asset Retirement Obligations" ("SFAS No 143"). SFAS No. 143 addresses accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The Company adopted the provisions of SFAS No.143 effective January 1, 2003. The adoption of SFAS No. 143 did not have an impact on the Company's financial position or results of operations.

In November of 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (an interpretation of FASB SFAS No. 5, 57, and 107 and rescission of FASB Interpretation No. 34)" ("FIN No. 45"). FIN No. 45 clarifies the requirements of FASB SFAS No. 5, "Accounting for Contingencies" ("SFAS No. 5") relating to a guarantor's accounting for, and disclosure of, the issuance of certain types of guarantees. FIN 45 provides for additional disclosure requirements related to guarantees, effective for financial periods ending after December 15, 2002. Additionally, FIN 45 outlines provisions for initial recognition and measurement of the liability incurred in providing a guarantee. These provisions are to be applied on a prospective basis to guarantees issued or modified after December 31, 2002. The Company has adopted the disclosure requirements of FIN No. 45 and the provisions for initial recognition and measurement for all guarantees issued or modified after December 31, 2002. The adoption of FIN 45 did not have a significant impact on the Company's financial position or results of operations.

In January of 2003, the FASB issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51 ("ARB No. 51")" ("FIN No. 46"). As a general rule, ownership by the parent, either directly or indirectly, of over fifty percent of the outstanding voting shares of a subsidiary is a condition pointing toward preparation of consolidated financial statements of the parent and its subsidiary. FIN No. 46 clarifies the exceptions to this general rule, as enunciated in paragraph 2 of ARB No. 51. FIN No. 46 requires an entity to consolidate a variable interest entity ("VIE") even though the entity does not, either directly or indirectly, own over fifty percent of the outstanding voting shares.

FIN No. 46 defines a VIE as one in which a) the equity investment is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties which is provided through other interests that will absorb some or all of the expected losses of the entity or b) the equity investors lack one or more of the following essential characteristics of a controlling financial interest i) direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights or ii) the obligation to absorb the expected losses of the entity, if they occur or receive residual returns of the entity, if they occur or iii) the right to receive the expected residual returns of the entity if they occur. The primary beneficiary of a VIE is required to consolidate the results of operations of the VIE. Financial statements issued after January 31, 2003 are required to disclose the nature, purpose, activities and size of the VIE and maximum exposure to loss as a result of its involvement with the VIE. The Company reviewed FIN No. 46 and is of the opinion that the Company is neither a primary beneficiary of a VIE nor does it have a significant involvement with a VIE.

In December 2002, the FASB issued SFAS No. 148 entitled "Accounting for Stock-Based Compensation, Transition and Disclosure" ("SFAS No.148"). SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also amends the disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation", to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company adopted this standard beginning with the 2002 annual financial statements. The Company has not adopted fair value accounting in 2003. The Company applies APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations, in accounting for its plans as allowed for under the provisions of SFAS No. 123. Accordingly, no compensation cost has been recognized for its stock-based incentive plans as the exercise price of the granted options equals the market price at the grant date. Had compensation cost for these plans been determined on the fair value at the grant date for options granted, the Company's pro forma net income for the six months ended June 30, 2003 and 2002 would have been $19.7 million and $23.4 million, respectively. Diluted net income per share would have been $0.45 and $0.55 for the six months ended June 30, 2003 and 2002, respectively.

In April of 2003, the FASB issued SFAS No. 149 entitled "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("SFAS No.149"). SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133 entitled "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"). SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The Company does not anticipate that the adoption of SFAS No. 149 to have a significant impact on the Company's financial position or results of operations.

In May of 2003, the FASB issued SFAS No. 150 entitled "Accounting for Certain Financial

Instruments with Characteristics of both Liabilities and Equity" ("SFAS No. 150"). SFAS No. 150 establishes standards for how an issuer of financial instruments classifies and measures in its statement of financial position certain instruments with characteristics of both liabilities and equity. SFAS No. 150 modifies the accounting and financial statement disclosures of certain financial instruments that, under previous guidance, issuers could account for as equity. SFAS No. 150 affects the issuer's accounting for three types of financial instruments that are required to be accounted for as liabilities.

SFAS No. 150 is effective for all financial instruments entered into or modified after May 31, 2003. For all financial instruments entered into prior to May 31, 2003, SFAS 150 is effective at the beginning of the first interim period beginning after June 15, 2003, which for CNA Surety begins July 1, 2003. The Company does not have any financial instruments outstanding to which provisions of SFAS 150 apply, therefore the adoption of SFAS 150 is not expected to have any impact on the Company's financial position or results of operations.

2. INVESTMENTS

The estimated fair value and amortized cost of fixed income and equity securities held by CNA Surety at June 30, 2003 and December 31, 2002, by investment category, were as follows (dollars in thousands):

June 30, 2003	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estim V
Fixed income securities:				
U.S. Treasury securities and obligations of				
U.S. Government and agencies:				
U.S. Treasury	$ 16,113	$ 1,152	$ --	$ 1
U.S. Agencies	6,555	345	(16)	
Collateralized mortgage obligations	90	3	--	
Mortgage pass-through securities	13,758	714	--	1
Obligations of states and political				
subdivisions...............................	360,720	29,762	(87)	39
Corporate bonds	68,317	7,412	(8)	7
Non-agency collateralized mortgage obligations..	8,787	634	(35)	
Other asset-backed securities:				
Second mortgages/home equity loans	10,139	652	--	1
Credit card receivables	5,000	97	--	
Other	7,498	945	--	
Redeemable preferred stock	13,406	1,540	--	1
Total fixed income securities	510,383	43,256	(146)	55
Equity securities	983	--	(20)	
Total	$511,366	$ 43,256	$ (166)	$55

December 31, 2002	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estima Va
Fixed income securities:				
U.S. Treasury securities and obligations of				
U.S. Government and agencies:				
U.S. Treasury	$ 16,140	$ 960	$ --	$ 1
U.S. Agencies	29,396	537	(3)	2
Collateralized mortgage obligations	156	7	--	
Mortgage pass-through securities	20,981	1,066	--	2
Obligations of states and political				
subdivisions...............................	347,918	20,099	(83)	36
Corporate bonds	76,181	6,154	(190)	8
Non-agency collateralized mortgage obligations..	10,497	477	(58)	1
Other asset-backed securities:				
Second mortgages/home equity loans	11,842	614	--	1
Credit card receivables	5,000	87	--	
Other	7,838	653	--	
Redeemable preferred stock	13,415	854	--	1
Total fixed income securities	539,364	31,508	(334)	57

Equity securities	852	--	(91)	
Total	$540,216	$ 31,508	$ (425)	$57

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.

CNA Surety classifies its fixed income securities and its equity securities as available-for-sale, and as

such, they are carried at fair value. The amortized cost of fixed income securities is adjusted for amortization of premiums and accretion of discounts to maturity, which is included in net investment income. Changes in fair value are reported as a component of other comprehensive income.

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 Consolidated Balance Sheets and Consolidated Statements of Income. The Company's Quantitative and Qualitative Discussion about Market Risk is contained in Item 3 of this Form 10-Q.

3. REINSURANCE

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

	Three Months Ended June 30,			
	2003		2002	
	Written	Earned	Written	Earned
Direct	$ 46,398	$ 39,212	$ 36,521	$ 32,975
Assumed	51,048	52,718	58,931	51,961
Ceded	(16,337)	(17,272)	(9,057)	(9,194)
	$ 81,109	$ 74,658	$ 86,395	$ 75,742

	Six Months Ended June 30,			
	2003		2002	
	Written	Earned	Written	Earned
Direct	$ 88,765	$ 75,515	$ 73,293	$ 64,688
Assumed	100,352	101,405	104,273	101,502
Ceded	(30,862)	(33,244)	(26,778)	(23,227)
	$ 158,255	$ 143,676	$ 150,788	$ 142,963

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 June 30,			
	2003		2002	
	$	Ratio	$	Ra
Gross losses and loss adjustment expenses	$ 44,006	47.9%	$ 23,092	2
Ceded amounts	(23,771)	137.6%	(3,486)	3
Net losses and loss adjustment expenses	$ 20,235	27.1%	$ 19,606	2

	Six Months Ended June 30,			
	2003		2002	
	$	Ratio	$	R
Gross losses and loss adjustment expenses	$ 71,919	40.7%	$ 41,156	2
Ceded amounts	(33,078)	99.5%	(4,903)	2
Net losses and loss adjustment expenses	$ 38,841	27.0%	$ 36,253	2

Assumed premiums primarily includes all surety business written or renewed, net of reinsurance, by Continental Casualty Company ("CCC") and The Continental Insurance Company ("CIC"), and their

affiliates, that is reinsured by Western Surety Company ("Western Surety") pursuant to intercompany reinsurance and related agreements.

2003 Third Party Reinsurance Compared to 2002 Third Party Reinsurance

Effective January 1, 2003, CNA Surety entered into a new excess of loss treaty ("2003 Excess of Loss Treaty") with a group of third party reinsurers that reduced its net retention per principal on new bonds to $15 million with a 5% co-participation in the $45 million layer of third party reinsurance coverage above the Company's retention. This new excess of loss treaty replaces the $40 million excess of $20 million per principal coverage ("2002 Excess of Loss Treaty"). The material differences between the new excess of loss reinsurance program and the Company's 2002 Excess of Loss Treaty are as follows. The annual aggregate coverage increases from $100 million in 2002 to $110 million in 2003. The minimum annual premium for the 2003 Excess of Loss Treaty is $38.0 million compared to $30.0 million of reinsurance premiums paid in 2002. The 2003 Excess of Loss Treaty provides the Company with coverage on a per principal basis of 95% of $45 million excess of $15 million retained by the Company.

The contract also includes similar special acceptance provisions for larger contract accounts contained in the 2002 Excess of Loss Treaty. In addition to the one large national contract principal and the two commercial principals excluded (based upon class of business in 2002), the Company's reinsurers have also excluded three other contract principals from the 2003 Excess of Loss Treaty for a total of six excluded principals. Of the two commercial principals, one is a domestic electric utility with an estimated bonded exposure of $54 million and is currently rated B by Standard and Poor's ("S&P"). The other is a foreign industrial concern with an estimated bonded exposure in excess of the Company's $60 million net retention per principal under the applicable reinsurance contracts. Management estimates that this concern has an equivalent S&P rating of B+. With respect to the three contract principals other than the large national contractor, two principals have substantially completed asset sales, debt reductions and other reorganization efforts. Each of these four principals continues to perform their contractual obligations underlying the Company's surety bonds.

The third contract principal is in claim and the claim adjustment process is in its early stages. Based upon currently available information, management believes that the reasonably possible net loss ranges from zero to $15.0 million, or equivalent to the Company's current per principal net retention under the 2003 Excess of Loss Treaty.

In March 2003, CNA Financial Corporation ("CNAF") entered into a credit agreement with the large national contractor, which undertakes projects for the construction of government and private facilities, to provide loans to the contractor in a maximum aggregate amount of $86.4 million (the "Credit Facility"). Of the $86.4 million capacity, $62.1 million, including accrued interest, was outstanding at June 30, 2003. The Credit Facility and all related loans will mature in March 2006. Advances under the Credit Facility bear interest at the prime rate plus 6%. Payment of 3% of the interest is deferred until the Credit Facility matures, and the remainder is to be paid monthly in cash. Loans under the Credit Facility are secured by a pledge of substantially all of the assets of the contractor and certain affiliates.

In addition, in June of 2003, CNAF and one of its subsidiaries provided repayment guarantees to certain creditors of the contractor and a subsidiary of the contractor amounting to $8.7 million. Such guarantees were provided in order to allow the contractor to receive financial accommodations from a creditor and in order to comply with certain regulatory requirements. Under the terms of the guarantees, any payments made by CNAF, or any of its subsidiaries, would be considered a draw under the Credit Facility.

CNA Surety has provided significant surety bond protection for projects by this contractor through surety bonds underwritten by CCC or its affiliates. The loans were provided by CNAF to help the contractor meet its liquidity needs.

In March of 2003, CNAF also purchased the contractor's outstanding bank debt for $16.4 million. The contractor retired the bank debt by paying CNAF $16.4 million, with $11.4 million of the payoff amount being funded under the new Credit Facility and $5 million from money loaned to the contractor by its shareholders. Under its purchase agreement with the banks, CNAF is also required to reimburse the banks for any draws upon approximately $6.5 million in outstanding letters of credit issued by the banks for the contractor's benefit that expire between May and August of 2003. Any amounts paid by CNAF to the banks as reimbursements for draws upon the banks' letters of credit will become obligations of the contractor to CNAF as draws upon the Credit Facility.

Loews Corporation ("Loews") has purchased a participation interest in one-third of the loans and commitments under the new Credit Facility, on a dollar-for-dollar basis, up to a maximum of $25 million. Although Loews does not have rights against the contractor directly under the participation agreement, it shares recoveries and certain fees under the credit facility proportionally with CNAF.

The contractor has initiated a restructuring plan that is intended to reduce costs and improve cash flow, and a chief restructuring officer has been appointed to manage execution of the plan. CNA Surety intends to continue to provide surety bonds on behalf of the contractor during this restructuring period, subject to the contractor's initial and ongoing compliance with CNA Surety's underwriting standards. Any losses arising from bonds issued or assumed by the insurance subsidiaries of CNA Surety to the contractor are excluded from CNA Surety's 2003 Excess of Loss Treaty. As a result, CNA Surety retains the first $60 million of losses on bonds written with an effective date of September 30, 2002 and prior, and CCC will incur 100% of losses above that retention level on bonds with effective dates prior to September 30, 2002. Through facultative reinsurance contracts with CCC, CNA Surety's exposure on bonds written from October 1, 2002 through December 31, 2002 has been limited to $20 million per bond.

Indemnification and subrogation rights, including rights to contract proceeds on construction projects in the event of default, exist that reduce CNA Surety's exposure to loss. While CNA Surety believes that the contractor's restructuring efforts are expected to be successful and provide sufficient cash flow for its operations, the contractor's failure to achieve its restructuring plan or perform its contractual obligations underlying all of the Company's surety bonds could have a material adverse effect on CNA Surety's future results of operations, cash flows and capital resources. If such failures occur, the Company estimates that possible losses, net of indemnification and subrogation recoveries, but before recoveries under reinsurance contracts, could be up to $200 million. However, the related party reinsurance treaties discussed below should limit the Company's per principal exposure to approximately $60 million.

Related Party Reinsurance

Intercompany 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 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 expires on December 31, 2003; and is annually renewable thereafter. There was no amount due to the CNA Surety insurance subsidiaries as of June 30, 2003.

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. 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 28% of net written premiums written on such business. As of June 30, 2003 and December 31, 2002, CNA Surety had an insurance receivable balance from CCC and CIC of $65.6 million and $49.5 million, respectively. CNA Surety had reinsurance payables to CCC and CIC of $5.9 million and $24.3 million as of June 30, 2003 and December 31, 2002, respectively, primarily related to reinsured losses.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expenses transferred to Western Surety 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 reestimated as of the end of such calendar quarter. There was not any adverse reserve development for the period from September 30, 1997 (date of inception) through June 30, 2003.

The Quota Share Treaty had an original term of five years from the Merger Date and was renewed on October 1, 2002 on substantially the same terms with an expiration date of December 31, 2003; and is annually renewable thereafter. The ceding commission paid to CCC and CIC by Western Surety remained at 28% of net written premiums and contemplates an approximate 4% override commission for fronting fees to CCC and CIC on their actual direct acquisition costs.

The Stop Loss Contract terminated on December 31, 2000 and was not renewed. The Stop Loss Contract protected the insurance subsidiaries 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 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 their 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 June 30, 2003, the Company had an estimated unpaid loss recoverable balance of approximately $13.3 million under the Stop Loss Contract.

The Excess of Loss Contracts provided the insurance subsidiaries of CNA Surety with the capacity to underwrite large surety bond exposures by providing

reinsurance support from CCC. The Excess of Loss Contract provides $75 million of coverage for losses in excess of the $60 million per principal. Subsequent to the Merger Date, the Company entered into a second excess of loss contract with CCC ("Second Excess of Loss Contract"). The Second Excess of Loss Contract provides additional coverage for principal losses that exceed the foregoing coverage of $75 million per principal provided by the Excess of Loss Contract, or aggregate losses per principal in excess of $135 million. In consideration for the reinsurance coverage provided by the Excess of Loss Contracts, the insurance subsidiaries paid to CCC, on a quarterly basis, a premium equal to 1% of the net written premiums applicable to the Excess of Loss Contract, subject to a minimum premium of $20,000 and $5,000 per quarter under the Excess of Loss Contract and Second Excess of Loss Contract, respectively. The two Excess of Loss Contracts collectively provided coverage for losses discovered on surety bonds in force as of the Merger Date and for losses

discovered on new and renewal business written during the term of the Excess of Loss Contracts. Both Excess of Loss Contracts commenced following the Merger Date and continued until September 30, 2002. The discovery period for losses covered by the Excess of Loss Contracts extends until September 30, 2005.

Effective October 1, 2002, the Company secured replacement excess of loss protection from CCC for per principal losses that exceed $60 million in two parts - a) $40 million excess of $60 million and b) $50 million excess of $100 million. This excess of loss protection is primarily necessary to support contract surety accounts with bonded backlogs or work-in-process in excess of $60 million. The Company generally limits support to large commercial surety accounts to $25 million. In addition to the foregoing structural changes in its high layer excess of loss reinsurance programs, the cost for these protections increased significantly as compared to the cost of the previous two Excess of Loss Contracts. The $40 million excess of $60 million contract is for a three year term beginning October 1, 2002 and provides annual aggregate coverage of $80 million and $120 million aggregate coverage for the entire three year term. The Company will pay CCC annual reinsurance premiums of $12.5 million in year one and $17.5 million in years two and three, payable quarterly. The Company may commute the contract at the end of each contract year under certain circumstances. The reinsurance premium for the coverage provided by the $50 million excess of $100 million contract was $6.0 million. This contract expires on December 31, 2003.

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 June 30,		
	2003	2002	
Reserves at beginning of period:			
Gross	254,118	$ 312,225	$

Ceded reinsurance	97,941	154,043	
Net reserves at beginning of period	$ 156,177	158,182	
Net incurred loss and loss adjustment expenses:			
Provision for insured events of current period	19,950	18,679	
Increase in provision for insured events of prior periods	285	927	
Total net incurred	20,235	19,606	
Net payments attributable to:			
Current period events	(1,238)	1,156	
Prior period events	16,896	16,559	
Total net payments	15,658	17,715	
Net reserves at end of period	160,754	160,073	
Ceded reinsurance at end of period	116,456	148,673	
Gross reserves at end of period	$ 277,210	$ 308,746	$

On January 2, 2003, CNA Surety settled litigation brought by J.P. Morgan Chase & Co. ("Chase") in connection with three surety bonds issued on behalf of Enron Corporation subsidiaries. The penal sums of the three bonds totaled approximately $78 million. Although the Company believed it had valid defenses to the litigation, based on the uncertainty and risk of an adverse jury verdict, pursuant to the settlement agreement, the Company paid Chase approximately $40.7 million and assigned its recovery rights in the Enron bankruptcy to Chase in exchange for a full release of its obligations under the bonds. The Company has no other exposure related to the Enron Corporation. CNA Surety's net loss related to the settlement, after anticipated recoveries under excess of loss reinsurance treaties, was previously fully reserved. Immediately upon execution of the settlement documents, the Company sent written notice for reimbursement to its reinsurers. A number of those reinsurers have requested a variety of documents and reserved their rights before making a decision concerning coverage of the settlement under the reinsurance treaties. The Company has provided all requested information. Three reinsurers responsible for payment of 34% of the treaty proceeds have paid their portions of the claim. Two other reinsurers have sent the Company letters expressing reservations about the claim. One reinsurer has denied coverage. Pursuant to the treaty, the Company has sent a notice demanding arbitration to all the reinsurers that have not paid. Management believes none of the reinsurers have valid defenses under the reinsurance treaties to avoid payment, and that the Company will fully recover all reinsurance recoverables recorded related to this settlement. As such, the Company has provided no valuation allowance with respect to these reinsurance recoverables as of June 30, 2003.

The company received claims on self insured workers compensation bonds furnished on behalf of three companies that have either recently filed for bankruptcy or have affiliates that filed for bankruptcy. The bonds were written in the 1970s and 1980s. The Company is in the process of investigating the total bond exposures involved, the underlying workers' claims that may be asserted against each bond, the ability of the principals to meet their contractual obligations underlying the Company's surety bonds and available reinsurance coverage. The Company currently has insufficient information to fully complete its claim evaluations, but the initial analysis indicates that the gross amount of exposure consists of approximately $46 million in bonds. Based upon currently available information, management believes

that the ultimate claims made under these bonds will be less than the total face amount of the bonds and that required claim payments would occur over a number of years. The resolution of these matters could have a material adverse impact on the future results of operations and financial position of the Company.

5. DEBT

On September 30, 2002, the Company refinanced $65 million in outstanding borrowings under its previous credit facility with a new credit facility (the "2002 Credit Facility"). The 2002 Credit Facility provided an aggregate of up to $65 million in initial borrowings divided between a 364-day revolving credit facility (the "Revolving Credit Facility") of $35 million and a three-year term loan facility (the "Term Loan") of $30 million. The Revolving Credit Facility may be extended, with the consent of lenders, for up to two additional periods of up to 364 days each, but in no case shall the Revolving Credit Facility be extended to mature on a date later than three years from the effective date of the Revolving Credit Facility. The Revolving Credit Facility may be increased from time to time by the amount of amortization under the Term Loan facility. Such increase is subject to consent by each Revolving Credit Bank, and will take place upon receipt by the Banks of the respective installment payments under the Term Loan facility.

Effective January 30, 2003, the Company entered into an interest rate swap on the $30 million Term Loan. As a result, the current effective interest rate on the term loan as of June 30, 2003 was 2.58%.

The Term Loan balance was reduced by $5 million on June 30, 2003 according to the scheduled amortization. Further amortization of the Term Loan will take place at $10,000,000 per year, in equal semi-annual installments of $5,000,000 on the following dates:

Date	Amortization	Outstanding Balance
September 30, 2003......................	5,000,000	20,000,000
March 31, 2004..........................	5,000,000	15,000,000
September 30, 2004......................	5,000,000	10,000,000
March 31, 2005..........................	5,000,000	5,000,000
September 30, 2005......................	5,000,000	0

The interest rate on borrowings under the 2002 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 a facility fee and utilization fee on the 2002 Credit Facility, was 0.625% at June 30, 2003 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 0.48% to 0.80%. As of June 30, 2003, the weighted average interest rate was 2.2% on the $55 million of outstanding borrowings. As of December 31, 2002, the weighted average interest rate on the 2002 Credit Facility was 2.0% on the $60 million of outstanding borrowings.

The 2002 Credit Facility contains, among other conditions, limitations on CNA Surety with respect to the incurrence of additional indebtedness and maintenance of a rating of at least "A" by A.M. Best Company Inc. for each of the Company's insurance subsidiaries. The 2002 Credit Facility also requires the

maintenance of certain financial ratios as follows: a) maximum funded debt to total capitalization ratio of 25%, b) minimum net worth of $350.0 million and c) minimum fixed charge coverage ratio of 2.5 times. As of June 30, 2002, the Company was in compliance with all restrictions and covenants contained in the 2002 Credit Facility.

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 June 30, 2003 was $0.8 million.

The consolidated balance sheet reflects total debt of $55.8 million at June 30, 2003 and $60.8 million at December 31, 2002. The weighted average interest rate on outstanding borrowings was 2.3% and 2.0% at June 30, 2003 and December 31, 2002 respectively.

6. COMMITMENTS AND CONTINGENCIES

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

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 ("CNA Surety" or the "Company") and its 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.

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 investments, deferred acquisition costs, goodwill and other intangible assets, reserves for unpaid losses and loss adjustment expenses and reinsurance. 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.

Investments

Management believes the Company has the ability to hold all fixed income securities to maturity. However, the Company may dispose of securities prior to their scheduled maturity due to changes in interest rates, prepayments, tax and credit considerations, liquidity or regulatory capital requirements, or other similar factors. As a result, the Company considers all of its fixed income securities (bonds and redeemable preferred stocks) and equity securities as available-for-sale. These securities are reported at fair value, with unrealized gains and losses, net of deferred income taxes, reported as a separate component of stockholders' equity. Cash flows from purchases, sales and maturities are reported gross in the investing activities section of the cash flow statement.

The amortized cost of fixed income securities is determined based on cost and the cumulative effect of amortization of premiums and accretion of discounts to maturity. Such amortization and accretion are included in investment income. For mortgage-backed and certain asset-backed securities, the Company recognizes income using the effective-yield method based on estimated cash flows. All securities transactions are recorded on the trade date. Investment gains or losses realized on the sale of securities are determined using the specific identification method. Investments with an other-than-temporary decline in value are written down to fair value, resulting in losses that are included in realized investment gains and losses.

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

Deferred Policy Acquisition Costs

Policy acquisition costs, consisting of commissions, premium taxes and other underwriting expenses which vary with, and are primarily related to, the production of business, net of reinsurance commissions, are deferred and amortized as a charge to income as the related premiums are earned. Anticipated investment income is considered in the determination of the recoverability of deferred acquisition costs.

Goodwill and Other Intangible Assets

CNA Surety's Consolidated Balance Sheet as of June 30, 2003 includes goodwill and identified intangibles of approximately $143.8 million. These amounts represent goodwill and identified intangibles arising from the acquisition of Capsure Holdings Corp. ("Capsure"). Prior to 2002, goodwill from this and other acquisitions were generally amortized as a charge to earnings over periods not exceeding 30 years. Under Statement of Financial Accounting Standards ("SFAS") No. 142 entitled "Goodwill and Other Intangible Assets" ("SFAS No. 142"), which was adopted by CNA Surety as of January 1, 2002, periodic amortization ceased, in accordance with an impairment-only accounting model.

A significant amount of judgment is required in performing goodwill impairment tests. Such tests include periodically determining or reviewing the estimated fair value of CNA Surety's reporting units. Under SFAS No. 142, fair value refers to the amount for which the entire reporting unit may be bought or sold. There are several methods of estimating fair value, including market quotations, asset and liability fair values and other valuation techniques, such as discounted cash flows and multiples of earnings or revenues. If the carrying 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 goodwill. The excess of the recorded amount of goodwill over the implied value of goodwill is recorded as an impairment loss.

Reserves for Unpaid Losses and Loss Adjustment Expenses and Reinsurance

CNA Surety accrues liabilities for unpaid losses and loss adjustment expenses 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. As of any balance sheet date, all claims have not yet 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 claims. Additionally, reported claims are in various stages of the settlement process. Each claim is settled individually based upon its merits, and certain claim liabilities may take years to settle, especially if legal action is involved.

The Company uses a variety of techniques to establish the liabilities for unpaid claims recorded at the balance sheet date. While techniques may vary, each employs significant judgments and assumptions. Techniques may involve detailed statistical analysis of past claim reporting, settlement activity, salvage and subrogation activity, 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. Techniques may vary depending on the type of claim being estimated. Liabilities may also reflect implicit or explicit assumptions regarding the potential effects of future economic and social inflation, judicial decisions, law changes, and recent trends in such factors.

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

CNA Surety's Consolidated Balance Sheet includes estimated liabilities for unpaid losses and loss adjustment expenses of $277.2 million and reinsurance receivables of $133.9 million at June 30, 2003. Due to the inherent uncertainties in the process of establishing these amounts, the actual ultimate claims amounts will differ from the currently recorded amounts. An incremental percentage change in estimates of this magnitude could result in a material effect on reported earnings. For example, a 10% increase in the June 30, 2003 net estimate for unpaid losses and loss adjustment expenses would produce approximately a $16.1 million charge to pre-tax earnings. Future effects from changes in these estimates will be recorded as a component of losses incurred in the period such changes are determined to be needed.

FORMATION OF CNA SURETY AND MERGER

In December 1996, CNA Financial Corporation ("CNAF") and Capsure agreed to merge (the "Merger") the surety business of CNAF with Capsure's insurance subsidiaries, Western Surety Company ("Western Surety") and Universal Surety of America ("USA"), into CNA Surety. CNAF, through its operating subsidiaries, writes multiple lines of property and casualty insurance, including surety

business that is reinsured by Western Surety. CNAF owns approximately 64% 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"). 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.

BUSINESS

CNA Surety's insurance subsidiaries write surety and fidelity bonds in all 50 states through a combined network of approximately 34,000 independent agencies. CNA Surety's principal insurance subsidiary is Western Surety. 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.

FINANCIAL STRENGTH RATINGS

A.M. BEST COMPANY, INC. ("A.M. BEST")

Western Surety is currently rated A+ (Superior), by A.M. Best. An A+ (Superior) rating is assigned to those companies which A.M. Best believes have achieved superior overall performance when compared to the norms of the property and casualty insurance industry. A+ (Superior) rated insurers have been shown to be among the strongest in ability to meet policyholder and other contractual obligations. Through intercompany reinsurance and related agreements, CNA Surety's customers have access to CCC's broader underwriting capacity. CCC is currently rated A (Excellent) by A.M. Best. A.M. Best's letter ratings range from A++ (Superior) to F (In Liquidation) with A++ being highest.

STANDARD AND POOR'S ("S&P")

CCC and Western Surety are both currently rated A- (Strong), by S&P. On August 7, 2003, S & P placed CCC and Western Surety on credit watch with negative implications. S&P's letter ratings range from AAA+ (Extremely Strong) to CC (Extremely Weak) with AAA+ being highest. Ratings from 'AA' to 'CCC' may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories. An insurer rated 'A' has strong financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.

"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 significant increases in corporate defaults on a national or global basis, the impact of competitive products, policies and pricing, product and policy development, regulatory changes and conditions including underwriting limitations imposed by the U.S. Department of Treasury, 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, the cost and availability of reinsurance

contracts on reasonable terms, 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

Financial Measures

The Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") discusses certain generally accepted accounting principles ("GAAP") and non-GAAP financial measures in order to provide information used by management to monitor the Company's operating performance. Management utilizes various financial measures to monitor the Company's insurance operations and investment portfolio. Underwriting results, which are derived from certain income statement amounts, are considered a non-GAAP financial measure and are used by management to monitor performance of the Company's insurance operations. The Company's investment portfolio is monitored through analysis of various quantitative and qualitative factors and certain decisions related to the sale or impairment of investments produce realized gains and losses, which is also a component used in the calculation of net income and is a non-GAAP financial measure.

Underwriting results are computed as net earned premiums less net loss and loss adjustment expenses and net commissions, brokerage and other underwriting expenses. Management uses underwriting income 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 claim and claim adjustment expenses to net earned premiums. The expense ratio is the percentage of net commissions, brokerage and other underwriting expenses, including the amortization of deferred acquisition costs, to net earned premiums. The combined ratio is the sum of the loss and expense ratios.

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

While management uses various 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 the operating performance and the impact to net income as a whole. Management also believes that investors may find these widely used non-GAAP 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.

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CNA SURETY RESULTS FOR THREE- AND SIX- MONTHS ENDED JUNE 30, 2003 AND 2002

The components of income for the Company for the three and six months ended June 30, 2003 and 2002 are summarized as follows (dollars in thousands):

	Three Months Ended June 30,		Si
	2003	2002	2003
Total revenues	$ 82,408	$ 84,464	$ 158,8
Underwriting income	$ 6,483	$ 10,542	$ 12,5
Net investment income	6,652	7,121	13,3
Net realized investment gains	1,098	1,601	1,8
Interest expense	455	445	8
Income before income taxes	13,778	18,819	26,9
Income taxes	3,517	5,917	7,1
Net income	$ 10,261	$ 12,902	$ 19,8
Net income per share	$ 0.24	$ 0.30	$ 0.

Insurance Underwriting

Underwriting results for the Company for the three and six months ended June 30, 2003 and 2002 are summarized in the following table (dollars in thousands):

	Three Months Ended June 30,		Six
	2003	2002	2003
Gross written premiums	$ 97,446	$ 95,452	$ 189,1
Net written premiums	$ 81,109	$ 86,395	$ 158,2

Net earned premiums..........................	$ 74,658	$ 75,742	$ 143,6
Net losses and loss adjustment expenses.......	20,235	19,606	38,8
Net commissions, brokerage and other underwriting expenses........................	47,940	45,594	92,2
Underwriting income..........................	$ 6,483	$ 10,542	$ 12,5
Loss ratio...................................	27.1%	25.9%	27
Expense ratio................................	64.2	60.2	64
Combined ratio...............................	91.3%	86.1%	91

Premiums Written

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

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

	Three Months Ended June 30,		Six
	2003	2002	2003
Contract.....................................	$ 59,165	$ 53,890	$ 100,7
Commercial...................................	31,160	34,897	73,1
Fidelity and other...........................	7,121	6,665	15,1
	$ 97,446	$ 95,452	$ 189,1

Gross written premiums increased 2.1%, or $2.0 million, for the three months ended June 30, 2003 over the comparable period in 2002. Contract surety gross written premiums increased 9.8%, or $5.3 million, as compared to 2002 primarily due to improving rates. Commercial surety in the second quarter of 2003 decreased by $3.7 million, or 10.7%, due to the Company's ongoing efforts to reduce aggregate exposures to large commercial accounts. In the second quarter of 2003, the Company experienced continued volume growth of small commercial products along with improving rates on large commercial and contract bonds. The estimated impact of the Company's large commercial account exposure

reduction of $1.7 billion for the first six months of 2003 represents approximately $8 million in annual premium, assuming an average rate per $1,000 of bond exposure of $4.51, or 45 basis points. Fidelity and other products increased 6.8%, or $0.5 million, to $7.1 million for the three months ended June 30, 2003 as compared to the same period in 2002 due primarily to volume growth in fidelity and E&O products.

Gross written premiums increased 6.5%, or $11.6 million, for the six months ended June 30, 2003 over the comparable period in 2002. Gross written premiums for contract surety and commercial surety increased 8.1%, or $7.5 million, and 4.6%, or $3.2 million, respectively for the six months ended June 30, 2003 reflecting trends comparable to the quarter. Fidelity and other products increased 5.9% to $15.2 million for the six months ended June 30, 2003 as compared to the same period in 2002 due primarily to volume growth in fidelity and E&O products.

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

	Three Months Ended June 30,		Six
	2003	2002	2003
Contract	$ 51,657	$ 49,947	$ 86,6
Commercial	22,654	30,094	57,0
Fidelity and other	6,798	6,354	14,4
	$ 81,109	$ 86,395	$ 158,2

For the three months ended June 30, 2003, net written premiums decreased 6.1%, or $5.3 million, to $81.1 million as compared to the same period in 2002, reflecting higher reinsurance costs partially offset by the aforementioned gross production changes. Ceded written premiums increased $7.3 million to $16.3 million for the second quarter of 2003 compared to the same period of last year primarily due to changes in the Company's reinsurance programs as more fully described below. Net written premiums for contract surety business increased 3.4%, or $1.7 million, to $51.7 million. Net written premiums for commercial surety decreased 24.7%, or $7.4 million, to $22.7 million for the three months ended June 30, 2003. Fidelity and other products increased 7.0%, or $0.4 million, to $6.8 million for the three months ended June 30, 2003 as compared to the same period in 2002.

For the six months ended June 30, 2003, net written premiums increased 5.0% to $158.3 million as compared to the same period in 2002, reflecting the aforementioned gross production changes partially offset by effects of higher reinsurance costs. Ceded written premiums increased $4.1 million to $30.9 million for the six months ended June 30, 2003. Net written premiums for contract surety business increased 6.8% to $86.7 million. Net written premiums for commercial surety increased 2.0% to $57.1 million for the first six months in 2003. Fidelity and other products increased 6.0% to $14.5 million for the first six months in 2003 as compared to the same period in 2002.

Excess of Loss Reinsurance

Beginning in 1999, the Company has experienced an increase in claim severity and frequency in the most recent accident years. CNA Surety is paying higher costs for reinsurance as a result of this loss experience.

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.

2003 Third Party Reinsurance Compared to 2002 Third Party Reinsurance

Effective January 1, 2003, CNA Surety entered into a new excess of loss treaty ("2003 Excess of Loss Treaty") with a group of third party reinsurers that reduced its net retention per principal on new bonds to $15 million with a 5% co-participation in the $45 million layer of third party reinsurance coverage above the Company's retention. This new excess of loss treaty replaces the $40 million excess of $20 million per principal coverage ("2002 Excess of Loss Treaty"). The material differences between the new excess of loss reinsurance program and the Company's 2002 Excess of Loss Treaty are as follows. The annual aggregate coverage increases from $100 million in 2002 to $110 million in 2003. The minimum annual premium for the 2003 Excess of Loss Treaty is $38.0 million compared to $30.0 million of reinsurance premiums paid in 2002. The 2003 Excess of Loss Treaty provides the Company with coverage on a per principal basis of 95% of $45 million excess of $15 million retained by the Company.

The contract also includes similar special acceptance provisions for larger contract accounts contained in the 2002 Excess of Loss Treaty. In addition to the one large national contract principal and the two commercial principals excluded (based upon class of business in 2002), the Company's reinsurers have also excluded three other contract principals from the 2003 Excess of Loss Treaty for a total of six excluded principals. Of the two commercial principals, one is a domestic electric utility with an estimated bonded exposure of $54 million and is currently rated B by Standard and Poor's ("S&P"). The other is a foreign industrial concern with an estimated bonded exposure in excess of the Company's $60 million net retention per principal under the applicable reinsurance contracts. Management estimates that this concern has an equivalent S&P rating of B+. With respect to the three contract principals other than the large national contractor, two principals have substantially completed asset sales, debt reductions and other reorganization efforts. Each of these four principals continues to perform their contractual obligations underlying the Company's surety bonds.

The third contract principal is in claim and the claim adjustment process is in its early stages. Based upon currently available information, management believes that the reasonably possible net loss ranges from zero to $15.0 million, or equivalent to the Company's current per principal net retention under the 2003 Excess of Loss Treaty.

In March 2003, CNA Financial Corporation ("CNAF") entered into a credit agreement with the large national contractor, which undertakes projects for the construction of government and private facilities, to provide loans to the contractor in a maximum aggregate amount of $86.4 million (the "Credit Facility"). Of the $86.4 million capacity, $62.1 million, including accrued interest, was outstanding at June 30, 2003. The Credit Facility and all related loans will mature in March 2006. Advances under the Credit Facility bear interest at the prime rate plus 6%. Payment of 3% of the interest is deferred until the Credit Facility matures, and the remainder is to be paid monthly in

cash. Loans under the Credit Facility are secured by a pledge of substantially all of the assets of the contractor and certain affiliates.

In addition, in June of 2003, CNAF and one of its subsidiaries provided repayment guarantees to certain creditors of the contractor and a subsidiary of the contractor amounting to $8.7 million. Such guarantees were provided in order to allow the contractor to receive financial accommodations from a creditor and in order to comply with certain regulatory requirements. Under the terms of the guarantees, any payments made by CNAF, or any of its subsidiaries, would be considered a draw under the Credit Facility.

CNA Surety has provided significant surety bond protection for projects by this contractor through surety bonds underwritten by CCC or its affiliates. The loans were provided by CNAF to help the contractor meet its liquidity needs.

In March of 2003, CNAF also purchased the contractor's outstanding bank debt for $16.4 million. The contractor retired the bank debt by paying CNAF $16.4 million, with $11.4 million of the payoff amount being funded under the new Credit Facility and $5 million from money loaned to the contractor by its shareholders. Under its purchase agreement with the banks, CNAF is also required to reimburse the banks for any draws upon approximately $6.5 million in outstanding letters of credit issued by the banks for the contractor's benefit that expire between May and August of 2003. Any amounts paid by CNAF to the banks as reimbursements for draws upon the banks' letters of credit will become obligations of the contractor to CNAF as draws upon the Credit Facility.

Loews Corporation ("Loews") has purchased a participation interest in one-third of the loans and commitments under the new Credit Facility, on a dollar-for-dollar basis, up to a maximum of $25 million. Although Loews does not have rights against the contractor directly under the participation agreement, it shares recoveries and certain fees under the credit facility proportionally with CNAF.

The contractor has initiated a restructuring plan that is intended to reduce costs and improve cash flow, and a chief restructuring officer has been appointed to manage execution of the plan. CNA Surety intends to continue to provide surety bonds on behalf of the contractor during this restructuring period, subject to the contractor's initial and ongoing compliance with CNA Surety's underwriting standards. Any losses arising from bonds issued or assumed by the insurance subsidiaries of CNA Surety to the contractor are excluded from CNA Surety's 2003 Excess of Loss Treaty. As a result, CNA Surety retains the first $60 million of losses on bonds written with an effective date of September 30, 2002 and prior, and CCC will incur 100% of losses above that retention level on bonds with effective dates prior to September 30, 2002. Through facultative reinsurance contracts with CCC, CNA Surety's exposure on bonds written from October 1, 2002 through December 31, 2002 has been limited to $20 million per bond.

Indemnification and subrogation rights, including rights to contract proceeds on construction projects in the event of default, exist that reduce CNA Surety's exposure to loss. While CNA Surety believes that the contractor's restructuring efforts are expected to be successful and provide sufficient cash flow for its operations, the contractor's failure to achieve its restructuring plan or perform its contractual obligations underlying all of the Company's surety bonds could have a material adverse effect on CNA Surety's future results of operations, cash flows and capital resources. If such failures occur, the Company

estimates that possible losses, net of indemnification and subrogation recoveries, but before recoveries under reinsurance contracts, could be up to $200 million. However, the related party reinsurance treaties discussed below should limit the Company's per principal exposure to approximately $60 million.

Related Party Reinsurance

Intercompany 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 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 expires on December 31, 2003; and is annually renewable thereafter. There was no amount due to the CNA Surety insurance subsidiaries as of June 30, 2003.

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. 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 28% of net written premiums written on such business. As of June 30, 2003 and December 31, 2002, CNA Surety had an insurance receivable balance from CCC and CIC of $65.6 million and $49.5 million, respectively. CNA Surety had reinsurance payables to CCC and CIC of $5.9 million and $24.3 million as of June 30, 2003 and December 31, 2002, respectively, primarily related to reinsured losses.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expenses transferred to Western Surety 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 reestimated as of the end of such calendar quarter. There was not any adverse reserve development for the period from September 30, 1997 (date of inception) through June 30, 2003.

The Quota Share Treaty had an original term of five years from the Merger Date and was renewed on October 1, 2002 on substantially the same terms with an expiration date of December 31, 2003; and is annually renewable thereafter. The ceding commission paid to CCC and CIC by Western Surety remained at 28% of net written premiums and contemplates an approximate 4% override commission for fronting fees to CCC and CIC on their actual direct acquisition costs.

The Stop Loss Contract terminated on December 31, 2000 and was not renewed. The Stop Loss Contract protected the insurance subsidiaries 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 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 their 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 June 30, 2003, the Company had an estimated unpaid loss recoverable balance of approximately $13.3 million under the Stop Loss Contract.

The Excess of Loss Contracts provided the insurance subsidiaries of CNA Surety with the capacity to underwrite large surety bond exposures by providing reinsurance support from CCC. The Excess of Loss Contract provides $75 million of coverage for losses in excess of the $60 million per principal. Subsequent to the Merger Date, the Company entered into a second excess of loss contract with CCC ("Second Excess of Loss Contract"). The Second Excess of Loss Contract provides additional coverage for principal losses that exceed the foregoing coverage of $75 million per principal provided by the Excess of Loss Contract, or aggregate losses per principal in excess of $135 million. In consideration for the reinsurance coverage provided by the Excess of Loss Contracts, the insurance subsidiaries paid to CCC, on a quarterly basis, a premium equal to 1% of the net written premiums applicable to the Excess of Loss Contract, subject to a minimum premium of $20,000 and $5,000 per quarter under the Excess of Loss Contract and Second Excess of Loss Contract, respectively. The two Excess of Loss Contracts collectively provided coverage for losses discovered on surety bonds in force as of the Merger Date and for losses discovered on new and renewal business written during the term of the Excess of Loss Contracts. Both Excess of Loss Contracts commenced following the Merger Date and continued until September 30, 2002. The discovery period for losses covered by the Excess of Loss Contracts extends until September 30, 2005.

Effective October 1, 2002, the Company secured replacement excess of loss protection from CCC for per principal losses that exceed $60 million in two parts - a) $40 million excess of $60 million and b) $50 million excess of $100 million. This excess of loss protection is primarily necessary to support contract surety accounts with bonded backlogs or work-in-process in excess of $60 million. The Company generally limits support to large commercial surety accounts to $25 million. In addition to the foregoing structural changes in its high layer excess of loss reinsurance programs, the cost for these protections increased significantly as compared to the cost of the previous two Excess of Loss Contracts. The $40 million excess of $60 million contract is for a three year term beginning October 1, 2002 and provides annual aggregate coverage of $80 million and $120 million aggregate coverage for the entire three year term. The Company will pay CCC annual reinsurance premiums of $12.5 million in year one and $17.5 million in years two and three, payable quarterly. The Company may commute the contract at the end of each contract year under certain circumstances. The reinsurance premium for the coverage provided by the $50 million excess of $100 million contract was $6.0 million. This contract expires on December 31, 2003.

Underwriting Income

Underwriting income decreased 38.5% to $6.5 million for the three months ended June 30, 2003 compared to $10.5 million for the same period in 2002. Underwriting income decreased 35.6% to $12.6 million for the six months ended June 30, 2003 compared to the same period in 2002. This decrease is primarily due to higher current accident year reserving and the impact of increased reinsurance costs on net earned premiums. Increased claim severity in recent

years has caused the Company to increase its estimates of gross and net incurred losses. In addition, these trends adversely impacted the cost and availability of reinsurance.

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 continued with various exposure management initiatives, particularly to reduce its risks on

large commercial accounts. As the following table depicts, the Company has reduced its exposure, before the effects of reinsurance, by 30% in 2003 on large commercial accounts, which are defined as accounts with exposures in excess of $10 million:

	Number of Accounts As of		Total Exposure (dollars in billi As of		
Commercial Account Exposure	June 30, 2003	December 31, 2002	June 30, 2003	December 31, 2002	% Reduc
$100 million and larger	8	14	$ 1.4	$ 2.7	46.
$ 50 to $ 100 million	13	19	0.9	1.2	32.
$ 25 to $ 50 million	18	16	0.6	0.6	
$ 10 to $ 25 million	70	75	1.1	1.2	11.
Total	109	124	$ 4.0	$ 5.7	30.

With respect to contract surety, the Company's portfolio is predominantly comprised of contractors with work programs of less than $50 million. "Work program" is the estimated contract value of uncompleted bonded and unbonded work. Bonded backlog is a measure of the Company's exposure in the event of default before indemnification, salvage and subrogation recoveries.

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

Net Loss Ratio

The net loss ratios for the three months ended June 30, 2003 and 2002 were 27.1% and 25.9%, respectively. The loss ratios included $0.3 million and $0.9 million of net unfavorable loss reserve development for the three months ended June 30, 2003 and 2002, respectively. Excluding the impact of loss reserve development, the net loss ratios would have been 26.7% and 24.7% for the period ended June 30, 2003 and June 30, 2002, respectively. For the six months ended June 30, 2003 and 2002, the net loss ratios were 27.0% and 25.4%, respectively. The loss ratios included $0.3 million and $0.9 million of net unfavorable reserve development for the six months ended June 30, 2003 and 2002, respectively. Excluding the impact of loss reserve development, the loss ratios would have been 26.8% and 24.8% for the six-month periods ended June 30, 2003

and June 30, 2002, respectively. The increase in the adjusted loss ratio in 2003 resulted from the Company's increased expected baseline accident year net loss ratio of branch contract and commercial business due to recent adverse loss trends together with uncertainties with respect to the economy and credit markets. The Company is using an initial 2003 accident year net loss ratio of 36.0% for the medium to large commercial and contract branch business compared to 30.0% in the first six months of 2002. This business represents about 52% of the Company's 2003 gross premiums.

On January 2, 2003, CNA Surety settled litigation brought by J.P. Morgan Chase & Co. ("Chase") in connection with three surety bonds issued on behalf of Enron Corporation subsidiaries. The penal sums of the three bonds totaled approximately $78 million. Although the Company believed it had valid defenses to the litigation, based on the uncertainty and risk of an adverse jury verdict, pursuant to the settlement agreement, the Company paid Chase approximately $40.7 million and assigned its recovery rights in the Enron bankruptcy to Chase in exchange for a full release of its obligations under the bonds. The Company has no other exposure related to the Enron Corporation. CNA Surety's net loss related to the settlement, after anticipated recoveries under excess of loss reinsurance treaties, was previously fully

reserved. Immediately upon execution of the settlement documents, the Company sent written notice for reimbursement to its reinsurers. A number of those reinsurers have requested a variety of documents and reserved their rights before making a decision concerning coverage of the settlement under the reinsurance treaties. The Company has provided all requested information. Three reinsurers responsible for payment of 34% of the treaty proceeds have paid their portions of the claim. Two other reinsurers have sent the Company letters expressing reservations about the claim. One reinsurer has denied coverage. Pursuant to the treaty, the Company has sent a notice demanding arbitration to all the reinsurers that have not paid. Management believes none of the reinsurers have valid defenses under the reinsurance treaties to avoid payment, and that the Company will fully recover all reinsurance recoverables recorded related to this settlement. As such, the Company has provided no valuation allowance with respect to these reinsurance recoverables as of June 30, 2003.

The company received claims on self insured workers compensation bonds furnished on behalf of three companies that have either recently filed for bankruptcy or have affiliates that filed for bankruptcy. The bonds were written in the 1970s and 1980s. The Company is in the process of investigating the total bond exposures involved, the underlying workers' claims that may be asserted against each bond, the ability of the principals to meet their contractual obligations underlying the Company's surety bonds and available reinsurance coverage. The Company currently has insufficient information to fully complete its claim evaluations, but the initial analysis indicates that the gross amount of exposure consists of approximately $46 million in bonds. Based upon currently available information, management believes that the ultimate claims made under these bonds will be less than the total face amount of the bonds and that required claim payments would occur over a number of years. The resolution of these matters could have a material adverse impact on the future results of operations and financial position of the Company.

Expense Ratio

The expense ratio increased to 64.2% for the three months ended June 30, 2003 compared to 60.2% for the same period in 2002. For the six months ended June 30, 2003, the expense ratio increased to 64.2% from 60.9% for the same period in 2002. The increase in the expense ratio for the three and six months

ended June 30, 2003 primarily reflects the impact of higher reinsurance costs on net earned premiums. Net earned premiums declined 1.4% and operating expenses increased 5.2% for the three months ended June 30, 2003. For the six months ended June 30, 2003, net earned premiums increased 0.5% and operating expenses increased at a higher rate of 5.8%.

Investment Income

For the three months ended June 30, 2003, net investment income was $6.7 million compared to the three months ended June 30, 2002 of $7.1 million. The decrease in investment income primarily reflects the impact of lower investment yields and higher investment in tax-exempt securities. The annualized pretax yields were 4.6% and 5.0% for the three months ended June 30, 2003 and 2002, respectively. The annualized after-tax yields for the Company's portfolio were 3.8% and 3.9% for the three months ended June 30, 2003 and 2002. Net investment income for the six months ended June 30, 2003 and 2002 was $13.4 million and $14.2 million, respectively. The annualized pretax yields were 4.6% and 5.0% for the six months ended June 30, 2003 and 2002. The annualized after-tax yields were 3.8% for both the six months ended June 30, 2003 and 2002.

Net realized investment gains were approximately $1.1 million for the three months ended June 30, 2003 compared to net realized investment gains of approximately $1.6 million for the same period in 2002. Net realized investment gains were approximately $1.8 million for the six months ended June 30, 2003 compared to net realized investment gains of approximately $1.3 for the same period in 2002.

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

	Three Months Ended June 30,		Six
	2003	2002	2003
Gross realized investment gains....................	$ 1,105	$ 2,028	$ 2,3
Gross realized investment losses...................	(7)	(427)	(5
Net realized investment gains......................	$ 1,098	$ 1,601	$ 1,8

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. The Company's Quantitative and Qualitative Discussion about Market Risk is contained in Item 3 of this Form 10-Q.

Analysis of Other Operations

Interest expense for the three months ended June 30, 2003 increased 2.3% as compared to the second quarter in 2002 Average debt outstanding was $60.8 million for the second quarter of 2003 compared to $76.2 million in the 2002. The weighted average interest rate for the three months ended June 30, 2003 was 2.4% compared to 2.1% for the same period in 2002. Interest expense decreased 10.5% for the first six months of 2003 as compared to the same period in 2002. Average debt outstanding was $60.8 million for the first six months in 2003 compared to $76.2 million in the first six months of 2002. The weighted average interest rate for the six months ended June 30, 2003 was 2.4% compared to 2.2% for the same period in 2002.

Income Taxes

Income tax expense was $3.5 million and $5.9 million and the effective income tax rates were 25.5% and 31.4% for the three months ended June 30, 2003 and 2002, respectively. For the six months ended June 30, 2003 and 2002, income tax expense was $7.1 million and $10.8 million and the effective income tax rates were 26.5% and 31.4%, respectively. The decrease in the estimated effective tax rate in 2003 primarily relates to anticipated increases in tax exempt investment income as a proportion of taxable income.

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 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, 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 June 30, 2003, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of $547.2 million of fixed income securities, $45.2 million of short-term investments, $1.1 million of other investments and $1.4 million of cash. At December 31, 2002, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of $564.8 million of fixed income securities, $41.9 million of short-term investments, $1.3 million of other investments and $10.7 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 June 30, 2003, the parent company's invested assets consisted of $6.3 million of fixed income securities, $1.0 million of equity securities, $13.3 million of short-term investments and $6.4 million of cash. At December 31, 2002, the parent company's invested assets consisted of $5.7 million of fixed income securities, $0.8 million of equity securities, $8.8 million of short-term investments and $4.3 million of cash. As of June 30, 2003 and December 31, 2002, parent company short-term investments and cash included $7.7 million and $4.8 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 used by operating activities was $20.6 million for the six months ended June 30, 2003 compared to net cash flow provided by operating activities of $37.0 million for the comparable period in 2002. The decrease in net cash flow provided by operating activities primarily relates to increased net loss payments, primarily related to settlement of litigation brought by Chase in connection with three surety bonds issued on behalf of Enron Corporation subsidiaries, and decreases in reinsurance and other payables to affiliates.

The Company refinanced $65 million in outstanding borrowings under its previous credit facility under a new credit facility (the "2002 Credit Facility"). The 2002 Credit Facility provided an aggregate of up to $65 million in initial borrowings divided between a 364-day revolving credit facility (the "Revolving Credit Facility") of $35 million and a three-year term loan facility (the "Term Loan") of $30 million. The Revolving Credit Facility may be extended, with the consent of lenders, for up to two additional periods of up to 364 days each, but in no case shall the Revolving Credit Facility be extended to mature on a date later than three years from the effective date of the Revolving Credit Facility. The Revolving Credit Facility may be increased from time to time by the amount of amortization under the Term Loan facility. Such increase is subject to consent by each Revolving Credit Bank, and will take place upon receipt by the Banks of the respective installment payments under the Term Loan facility.

Outstanding borrowings under the 2002 Credit Facility were $55 million as of June 30, 2003, consisting of $30 million under the Revolving Credit Facility and $25 million under the Term Loan Facility. Effective January 30, 2003, the Company entered into an interest rate swap on the $30 million Term Loan. As a result, the current effective interest rate on the term loan as of June 30, 2003 was 2.58%.

The Term Loan balance was reduced by $5 million on June 30, 2003 according to the scheduled amortization. Further amortization of the Term Loan will take place at $10,000,000 per year, in equal semi-annual installments of $5,000,000 on the following dates:

Date	Amortization	Outstanding Balance
September 30, 2003.....................	5,000,000	20,000,000
March 31, 2004.........................	5,000,000	15,000,000
September 30, 2004.....................	5,000,000	10,000,000
March 31, 2005.........................	5,000,000	5,000,000
September 30, 2005.....................	5,000,000	0

The interest rate on borrowings under the 2002 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 a facility fee and utilization fee on the 2002 Credit Facility, was 0.625% at June 30, 2003 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 0.48% to 0.80%. As of June 30, 2003, the weighted average interest rate was 2.2% on the $55 million of outstanding borrowings. As of December 31, 2002, the weighted average interest rate on the 2002 Credit Facility was 2.0% on the $60 million of outstanding borrowings.

The 2002 Credit Facility contains, among other conditions, limitations on CNA Surety with respect to the incurrence of additional indebtedness and maintenance of a rating of at least "A" by A.M. Best Company Inc. for each of the Company's insurance subsidiaries. The 2002 Credit Facility also requires the maintenance of certain financial ratios as follows: a) maximum funded debt to total capitalization ratio of 25%, b) minimum net worth of $350.0 million and c) minimum fixed charge coverage ratio of 2.5 times. As of June 30, 2003, the Company was in compliance with all restrictions and covenants contained in the 2002 Credit Facility.

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 June 30, 2003 was $0.8 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 2003 is based on statutory surplus and income at and for the year ended December 31, 2002. Without prior regulatory approval in 2003, CNA Surety's insurance subsidiaries may pay stockholder dividends of $32.1

million in the aggregate. CNA Surety received $10.0 million and $12.0 million in dividends from its insurance subsidiaries during the first six months of 2003 and 2002, respectively. A dividend of $10.0 million was received by CNA Surety from its insurance subsidiaries on July 24, 2003.

Combined statutory surplus totaled $240.5 million at June 30, 2003, resulting in a net written premium to statutory surplus ratio of 1.3 to 1. Approximately $226 million of the combined surplus relates to Western Surety. Insurance regulations restrict Western Surety's maximum net retention on a single surety bond to 10 percent of statutory surplus. Under the 2003 Excess of Loss Treaty, the Company's net retention on new bonds would generally be $15 million plus a 5% co-participation in the $45 million layer of excess reinsurance above the Company's retention and this regulation would require minimum statutory surplus of $172.5 million at Western Surety. This surplus constraint may limit the amount of future dividends Western Surety could otherwise pay to CNA Surety.

In accordance with the provisions of intercompany tax sharing agreements between CNA Surety and its subsidiaries, the tax of each subsidiary shall be determined based upon each subsidiary's separate return liability. Intercompany tax payments are made at such times as estimated tax payments would be required by the Internal Revenue Service ("IRS"). CNA Surety received tax sharing payments from its subsidiaries of $6.2 million for the six months ended June 30, 2003 and $3.5 million for the same period in 2002.

Western Surety and SBCA each qualifies 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. The underwriting limitations of Western Surety, SBCA and USA, based on each insurer's statutory surplus, were $20.7 million, $0.5 million and $1.3 million, respectively, for the twelve month period ended June 30, 2003. Effective July 1, 2003 through June 30, 2004, the underwriting limitations of Western Surety and SBCA are $21.9 million and $0.5 million, respectively. Through the Surety Quota Share Treaty between CCC and Western Surety Company, CNA Surety has access to CCC and its affiliates' U.S. Department of Treasury underwriting limitations. The Surety Quota Share Treaty had an original term of five years from the Merger Date and was renewed on October 1, 2002 on substantially the same terms. Effective July 1, 2003 through June 30, 2004, the underwriting limitations of CCC and its affiliates total $569.6 million. CNA Surety management believes that the foregoing U.S. Treasury underwriting limitations are sufficient for the conduct of its business.

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCUSSIONS 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 June 30, 2003. 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 table.

(dollars in thousands)	Fair Value at June 30, 2003	Hypothetical Change in Interest Rate (bp=basis points)
Fixed Income Securities:		
U.S. Government and government agencies and authorities....	$ 38,714	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
States, municipalities and political subdivisions..........	390,395	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
Corporate bonds and all other............................	124,384	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
Total fixed income securities..........................	$ 553,493	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease

Hypothetical

(dollars in thousands)	Fair Value at December 31, 2002	Change in Interest Rate (bp=basis points)
Fixed Income Securities:		
U.S. Government and government agencies and authorities....	$ 69,240	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
States, municipalities and political subdivisions..........	367,934	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
Corporate bonds and all other............................	133,364	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
Total fixed income securities..........................	$ 570,538	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease

ITEM 4. CONTROLS AND PROCEDURES

The Company, under the direction of the Chief Executive Officer and the Chief Financial Officer, has established disclosure controls and procedures that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. The disclosure controls and procedures are also intended to ensure that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures.

Within 90 days before the filing of this Report, the Chief Executive Officer and the Chief Financial Officer have reviewed and evaluated the Company's disclosure controls and procedures. Based on this review and evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Company's disclosure controls and procedures are operating effectively.

In addition, there have been no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of the most recent evaluation. No significant deficiencies or material weaknesses in the internal controls were identified during the evaluation and, as a consequence, no corrective action is required.

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 -

At the Annual Meeting of Shareholders of CNA Surety Corporation held on May 13, 2003, the Company's shareholders voted on the following proposals. The numbers of shares issued, outstanding and eligible to vote as of the record date of March 17, 2003 were 42,958,957. Proxies representing 41,155,282 shares or approximately 96 percent of the eligible voting shares were tabulated.

PROPOSAL I

Election of Directors.

	Number of Shares/Votes	
	For	Authority Withheld
Philip H. Britt	41,096,833	58,449
James R. Lewis	40,324,191	831,091
Roy E. Posner	39,462,795	1,692,487
Adrian M. Tocklin	39,461,202	1,694,080
Mark C. Vonnahme	40,213,036	942,246

PROPOSAL II

To ratify the Board of Directors' appointment of the Company's independent auditors, Deloitte & Touche LLP for fiscal year 2003.

For	41,044,900
Against	6,716
Abstain	103,666

ITEM 5. Other Information - None.

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

(a) Exhibits: -

10(1) Employment Agreement dated as of June 30, 2003 by and between CNA Surety Corporation and John F. Welch.

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.

CNA SURETY CORPORATION AND SUBSIDIARIES

PART II - OTHER INFORMATION (continued)

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

(b) Reports on Form 8-K:

May 6, 2003; CNA Surety Corporation Press Release issued on May 5, 2003.

June 17, 2003; CNA Surety Corporation Press Release issued on June 17, 2003.

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/ Mark C. Vonnahme

Mark C. Vonnahme
President and Chief Executive Officer

/s/ John S. Heneghan

John S. Heneghan
Senior Vice President and Chief Financial Officer

Date: August 12, 2003