

Edgar Filing: CNA SURETY CORP - Form 10-Q

CNA SURETY CORP
Form 10-Q
May 10, 2004

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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

For the quarterly period ended MARCH 31, 2004

OR

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

Commission file number: 1-13277

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

DELAWARE
(State or other jurisdiction of
incorporation or organization)

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

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

60685
(Zip Code)

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

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

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

42,993,446 shares of Common Stock, \$.01 par value as of May 3, 2004.

CNA SURETY CORPORATION AND SUBSIDIARIES

INDEX

PART I. FINANCIAL INFORMATION:

Edgar Filing: CNA SURETY CORP - Form 10-Q

Item 1. Condensed Consolidated Financial Statements:

Independent Accountants' Report

Condensed Consolidated Balance Sheets at March 31, 2004 and at December 31, 2003 (Unaudited).....

Condensed Consolidated Statements of Income for the Three Months Ended March 31, 2004 and 2003 (Unaudited).....

Condensed Consolidated Statements of Stockholders' Equity for the Three Months Ended March 31, 2004 and 2003 (Unaudited).....

Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2004 and 2003 (Unaudited).....

Notes to Condensed Consolidated Financial Statements (Unaudited)

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.....

Item 3. Quantitative and Qualitative Disclosures About Market Risk.....

Item 4. Disclosure Controls and Procedures.....

PART II. OTHER INFORMATION:

Item 1. Legal Proceedings.....

Item 2. Changes in the Rights of the Company's Security Holders.....

Item 3. Defaults Upon Senior Securities.....

Item 4. Submission of Matters to a Vote of Security Holders.....

Item 5. Other Information.....

Item 6. Exhibits and Reports on Form 8-K

PART I. FINANCIAL INFORMATION

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 March 31, 2004, and the related condensed consolidated statements of income, stockholders' equity and cash flows for the three-month periods ended March 31, 2004 and 2003. These interim financial statements are the responsibility of the Corporation's management.

We conducted our reviews in accordance with standards established by the

Edgar Filing: CNA SURETY CORP - Form 10-Q

American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with 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 reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of CNA Surety Corporation and subsidiaries as of December 31, 2003, 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 March 12, 2004, 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, 2003 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Deloitte & Touche LLP
Chicago, Illinois
May 6, 2004

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

ASSETS

Invested assets and cash:

Fixed income securities, at fair value (amortized cost: \$607,765 and \$544,201).....
Equity securities, at fair value (cost: \$3,041 and \$992).....
Short-term investments, at cost (approximates fair value).....
Other investments, at fair value.....

Total invested assets.....

Cash.....

Deferred policy acquisition costs.....

Insurance receivables:

Premiums, including \$13,757 and \$18,394 from affiliates (net of allowance for doubtful accounts: \$1,575 and \$1,575).....

Reinsurance, including \$8,685 and \$52,704 from affiliates.....

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

Current income taxes receivables.....

Property and equipment, at cost (less accumulated

Edgar Filing: CNA SURETY CORP - Form 10-Q

depreciation: \$19,619 and \$18,944).....
 Prepaid reinsurance premiums.....
 Accrued investment income.....
 Other assets.....

 Total assets.....

LIABILITIES

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

 Total reserves.....
 Debt.....
 Deferred income taxes, net.....
 Reinsurance and other payables to affiliates.....
 Accrued expenses.....
 Other liabilities.....

 Total liabilities.....

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

STOCKHOLDERS' EQUITY

Common stock, par value \$.01 per share, 100,000 shares authorized; 44,407
 shares issued and 42,993 shares outstanding at March 31, 2004 and 44,401
 shares issued and 42,980 shares outstanding at December 31, 2003.....
 Additional paid-in capital.....
 Retained earnings.....
 Accumulated other comprehensive income.....
 Treasury stock, at cost.....

 Total stockholders' equity.....

 Total liabilities and stockholders' equity.....

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

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

Revenues:
 Net earned premium.....
 Net investment income.....
 Net realized investment gains.....

Edgar Filing: CNA SURETY CORP - Form 10-Q

Total revenues.....	
Expenses:	
Net losses and loss adjustment expenses.....	
Net commissions, brokerage and other underwriting expenses.....	
Interest expense.....	
Total expenses.....	
Income before income taxes.....	
Income taxes.....	
Net income.....	
Earnings per share.....	
Earnings per share, assuming dilution.....	
Weighted average shares outstanding.....	
Weighted average shares outstanding, assuming dilution.....	

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	ADD PA CA
	-----	-----	-----
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 (\$958).....	--	--	
Total comprehensive income.....			
Issuance of treasury stock to employee stock purchase program...	9	--	
Stock options exercised and other.....	3	--	
	-----	-----	-----
Balance, March 31, 2003.....	42,959	\$ 444	\$
	=====	=====	=====
Balance, December 31, 2003.....	42,980	\$ 444	\$
Comprehensive income:			
Net income.....	--	--	
Other comprehensive income:			

Edgar Filing: CNA SURETY CORP - Form 10-Q

Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of \$1,549.....	--		--
Total comprehensive income.....			
Issuance of treasury stock to employee stock purchase program...	7		--
Stock options exercised and other.....	6		--
	<u>-----</u>		<u>-----</u>
Balance, March 31, 2004.....	42,993	\$	444 \$
	<u>=====</u>		<u>=====</u>

	RETAINED EARNINGS		ACCUMULATED OTHER COMPREHENSIVE INCOME
	<u>-----</u>		<u>-----</u>
Balance, December 31, 2002.....	\$ 159,937	\$	19,861
Comprehensive income:			
Net income.....	10,989		--
Other comprehensive income:			
Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of (\$958).....	--		992
Issuance of treasury stock to employee stock purchase program...			
Stock options exercised and other.....	1		--
	<u>-----</u>		<u>-----</u>
Balance, March 31, 2003.....	\$ 170,927	\$	20,853
	<u>=====</u>		<u>=====</u>
Balance, December 31, 2003.....	\$ 145,786	\$	23,351
Comprehensive income:			
Net income.....	6,374		--
Other comprehensive income:			
Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of \$1,549.....	--		1,491
Issuance of treasury stock to employee stock purchase program...			
Stock options exercised and other.....	--		--
	<u>-----</u>		<u>-----</u>
Balance, March 31, 2004	\$ 152,160	\$	24,842
	<u>=====</u>		<u>=====</u>

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

Edgar Filing: CNA SURETY CORP - Form 10-Q

OPERATING ACTIVITIES:

Net income.....
Adjustments to reconcile net income to net cash provided by (used in) operating activities:
 Depreciation and amortization.....
 Accretion of bond discount, net.....
 Net realized investment gains.....
Changes in:
 Insurance receivables.....
 Reserve for unearned premiums.....
 Reserve for unpaid losses and loss adjustment expenses.....
 Deferred policy acquisition costs.....
 Deferred income taxes, net.....
 Reinsurance and other payables to affiliates.....
 Prepaid reinsurance premiums.....
 Other assets and liabilities.....

 Net cash provided by (used in) operating activities.....

INVESTING ACTIVITIES:

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

 Net cash (used in) provided by investing activities.....

FINANCING ACTIVITIES:

Principal payments on debt.....
Employee stock option exercises.....
Issuance of treasury stock to employee stock purchase plan.....

 Net cash (used in) provided by financing activities.....

Decrease in cash.....
Cash at beginning of period.....

Cash at end of period.....

Supplemental Disclosure of Cash Flow Information:

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

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

Edgar Filing: CNA SURETY CORP - Form 10-Q

1. SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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.

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 2003 10-K. Certain financial information that is included in annual financial statements prepared in accordance with GAAP, is not required for interim reporting and has been condensed or omitted. The accompanying unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all adjustments necessary for a fair presentation of the interim financial statements. All such adjustments are of a normal and recurring nature. The financial results for interim periods may not be indicative of financial results for a full year. Certain reclassifications have been made to the 2003 Financial Statements to conform with the presentation in the 2004 Condensed Consolidated Financial Statements.

Earnings Per Share

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

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

THREE MONTHS ENDED M

Edgar Filing: CNA SURETY CORP - Form 10-Q

	2004

Net income.....	\$ 6,374
	=====
Shares:	
Weighted average shares outstanding.....	42,980
Weighted average shares of options exercised.....	11

Total weighted average shares outstanding.....	42,991
Effect of dilutive options.....	64

Total weighted average shares outstanding, assuming dilution.....	43,055
	=====
Earnings per share.....	\$ 0.15
	=====
Earnings per share, assuming dilution.....	\$ 0.15
	=====

No adjustments were made to reported net income in the computation of earnings per share.

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

8

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

	THREE MONTHS ENDED M	

(IN THOUSANDS, EXCEPT PER SHARE DATA)	2004	
	-----	-----
Net income.....	\$ 6,374	\$
Less: Total stock based compensation cost determined under the fair value method, net of tax.....	(70)	
	-----	-----
Pro forma net income.....	\$ 6,304	\$
	=====	=====
Basic and diluted earnings per share, as reported.....	\$ 0.15	\$
	=====	=====
Basic and diluted earnings per share, pro forma.....	\$ 0.15	\$
	=====	=====

Accounting Changes

In January of 2003, the Financial Accounting Standards Board ("FASB")

Edgar Filing: CNA SURETY CORP - Form 10-Q

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 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 has adopted FIN No. 46. In December 2003, the FASB issued a revision to FIN No. 46 ("Fin No. 46R") that further clarified the application of ARB No. 51. The Company has adopted FIN No. 46R. The Company is neither a primary beneficiary of a VIE nor does it have a significant involvement with a VIE.

In December of 2003, the FASB revised SFAS No. 132 entitled "Employers' Disclosures about Pensions and Other Postretirement Benefits" ("SFAS No. 132") to require additional disclosures related to pensions and post retirement benefits. While retaining the existing disclosure requirements for pensions and postretirement benefits, additional disclosures are required related to pension plan assets, obligations, contributions and net benefit costs, beginning with fiscal years ending after December 15, 2003. Additional disclosures pertaining to benefit payments are required for fiscal years ending after June 30, 2004. The SFAS No. 132 revisions also include additional disclosure requirements for interim financial reports beginning after December 15, 2003. The Company has implemented the interim disclosure requirements in these financial statements and will include annual benefit payment disclosures in all subsequent annual financial statements.

2. INVESTMENTS

The estimated fair value and amortized cost of fixed income and equity securities held by CNA Surety at March 31, 2004 and December 31, 2003, by investment category, were as follows (dollars in thousands):

MARCH 31, 2004	AMORTIZED COST OR COST	GROSS UNREALIZED GAINS	GROSS UNRE LESS THAN 1 MONTHS

Fixed income securities:

Edgar Filing: CNA SURETY CORP - Form 10-Q

U.S. Treasury securities and obligations of U.S. Government and agencies:

U.S. Treasury.....	\$ 21,234	\$ 883	\$ --
U.S. Agencies.....	4,585	112	(3)
Collateralized mortgage obligations.....	10,042	1	(4)
Mortgage pass-through securities.....	48,090	624	(6)
Obligations of states and political subdivisions.....	385,136	27,689	(32)
Corporate bonds.....	109,869	7,009	(1)
Non-agency collateralized mortgage obligations.....	8,516	549	--
Other asset-backed securities:			
Second mortgages/home equity loans.....	5,389	470	--
Credit card receivables.....	5,000	35	--
Other.....	4,548	321	--
Redeemable preferred stock.....	5,356	874	--
	-----	-----	-----
Total fixed income securities.....	607,765	38,567	(45)
Equity securities.....	3,041	200	--
	-----	-----	-----
Total.....	\$ 610,806	\$ 38,767	\$ (45)
	=====	=====	=====

	AMORTIZED COST OR COST	GROSS UNREALIZED GAINS	GROSS UNRE LESS THAN 1 MONTHS
DECEMBER 31, 2003			
-----	-----	-----	-----
Fixed income securities:			
U.S. Treasury securities and obligations of U.S. Government and agencies:			
U.S. Treasury.....	\$ 21,267	\$ 497	\$ --
U.S. Agencies.....	4,587	47	(9)
Collateralized mortgage obligations.....	76	1	--
Mortgage pass-through securities.....	7,607	386	--
Obligations of states and political subdivisions.....	376,961	25,604	(12)
Corporate bonds.....	96,525	7,322	(4)
Non-agency collateralized mortgage obligations.....	8,443	424	--
Other asset-backed securities:			
Second mortgages/home equity loans.....	5,721	426	--
Credit card receivables.....	5,000	51	--
Other.....	4,619	192	(1)
Redeemable preferred stock.....	13,395	1,238	--
	-----	-----	-----
Total fixed income securities.....	544,201	36,188	(28)
Equity securities.....	992	69	--
	-----	-----	-----
Total.....	\$ 545,193	\$ 36,257	\$ (28)
	=====	=====	=====

The Company's investment portfolio generally is managed to maximize after-tax investment return, while minimizing credit risk with investments concentrated in high quality 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,

Edgar Filing: CNA SURETY CORP - Form 10-Q

credit and tax considerations. These activities will produce realized gains and losses.

10

CNA Surety classifies its fixed maturity securities and its equity securities as available-for-sale, and as such, they are carried at fair value. The amortized cost of fixed maturity 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 Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Income. The Company's Quantitative and Qualitative Disclosures about Market Risk are 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 MARCH 31,			
	2004		2003	
	WRITTEN	EARNED	WRITTEN	EARNED
Direct.....	\$ 66,070	\$ 48,835	\$ 42,367	\$ 36,303
Assumed.....	29,809	43,893	49,304	48,687
Ceded.....	(24,325)	(17,531)	(12,337)	(13,784)
	<u>\$ 71,554</u>	<u>\$ 75,197</u>	<u>\$ 79,334</u>	<u>\$ 71,206</u>

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		
	2004		
	\$	RATIO	
Gross losses and loss adjustment expenses.....	\$ 23,336	25.2%	\$
Ceded amounts.....	(2,705)	15.4%	
Net losses and loss adjustment expenses.....	<u>\$ 20,631</u>	<u>27.4%</u>	<u>\$</u>

Edgar Filing: CNA SURETY CORP - Form 10-Q

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.

2004 Third Party Reinsurance Compared to 2003 Third Party Reinsurance

Effective January 1, 2004, CNA Surety entered into a new excess of loss treaty ("2004 Excess of Loss Treaty") with a group of third party reinsurers that reduced its net retention per principal to \$10 million with a 5% co-participation in the \$90 million layer of third party reinsurance coverage above the Company's retention. This new excess of loss treaty replaces the \$45 million excess of \$15 million per principal coverage, as well as the \$40 million excess of \$60 per principal and the \$3 million excess of \$12 million coverage that had been provided by CCC. The significant differences between the new excess of loss reinsurance program and the Company's 2003 Excess of Loss Treaty are as follows. The annual aggregate coverage increases from \$110 million in 2003 to \$157 million in 2004. The minimum annual premium for the 2004 excess of loss treaty is \$49.2 million (net of expected return premium) compared to a total of \$42.0 million of reinsurance premiums paid in 2003 (net of expected return premium) for the \$45 million excess of \$15 million, the \$40 million excess of \$60 million and the \$3 million excess of \$12 million treaties. The contract also includes an optional twelve month extended discovery period, for an additional premium, which will provide coverage for losses discovered in 2005 on bonds that were in force during 2004, and somewhat less restrictive special acceptance provisions for larger contract accounts than those contained in the 2003 Excess of Loss Treaty.

In addition to the one large contract principal (described later) and the two commercial principals excluded (based upon class of business), the Company's reinsurers had excluded three other contract principals from the 2003 Excess of Loss Treaty, for a total of six excluded principals. With respect to the three contract principals other than the large national contractor, two contract principals have completed asset sales and other reorganization efforts and have been accepted into the 2004 Excess of Loss Treaty. The third

11

went into claim in 2003. Although in claim and experiencing financial difficulties, the contractor continued to perform substantially all of its contractual obligations underlying the Company's surety bonds. The one large contract principal and the two commercial principals remain excluded from the 2004 Excess of Loss Treaty. Of the two commercial principals, one is a domestic electric utility with an estimated bonded exposure of \$46 million and is currently rated B- by Standard and Poor's ("S&P"). The bonded exposure will decline over the term of the bond which extends until 2007. The other is a foreign industrial enterprise with an estimated bonded exposure of \$13 million. The remaining exposure is expected to be discharged by June 30, 2004.

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 of these agreements originally were entered into on September 30, 1997 (the "Merger Date"): (i) the Surety Quota Share Treaty (the "Quota Share Treaty"); (ii) the Aggregate Stop Loss Reinsurance Contract (the "Stop Loss Contract"); and (iii) the Surety Excess of Loss Reinsurance Contract (the "Excess of Loss Contract").

Edgar Filing: CNA SURETY CORP - Form 10-Q

All of these contracts have expired. Some have been renewed on different terms as described below.

The Services and Indemnity Agreement provides the Company's insurance subsidiaries with the authority to perform various administrative, management, underwriting and claim functions in order to conduct the business of CCC and CIC and to be reimbursed by CCC for services rendered. In consideration for providing the foregoing services, CCC has agreed to pay Western Surety a quarterly fee of \$50,000. This agreement was renewed on January 1, 2004 and expires on December 31, 2004 and is annually renewable thereafter. There was no amount due to the CNA Surety insurance subsidiaries as of March 31, 2004.

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.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of September 30, 1997 by agreeing to pay Western Surety, within 30 days following the end of each calendar quarter, the amount of any adverse development on such reserves, as re-estimated as of the end of such calendar quarter. There was no adverse reserve development for the period from September 30, 1997 (date of inception) through March 31, 2004.

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. The Quota Share Treaty was again renewed on January 1, 2004 on substantially the same terms with an expiration date of December 31, 2004; 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 the accident years 1997 through 2000 on certain insured accounts (the "Loss Ratio Cap"), the Stop Loss Contract requires CCC at the end of each calendar quarter following the Merger Date, to pay to the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which 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 March 31, 2004, the Company had billed and received \$54.9 million under the Stop Loss Contract.

The Excess of Loss Contract 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 provided \$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 provided additional coverage for principal losses that exceed the foregoing coverage of \$75 million per principal provided by the Excess of Loss Contract,

Edgar Filing: CNA SURETY CORP - Form 10-Q

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

12

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 for new 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.

Effective January 1, 2004, the Company obtained replacement coverage from third party reinsurers as part of the 2004 Excess of Loss Treaty. Accordingly, the \$40 million excess of \$60 million contract with CCC was commuted effective January 1, 2004. As part of this commutation, the Company has received a commutation payment of \$10.9 million from CCC. As of December 31, 2003 the full amount of the commutation payment had been recognized as a receivable. The Company and CCC entered into a new \$40 million excess of \$60 million reinsurance contract providing coverage exclusively for the one large national contractor that is excluded from the Company's third party reinsurance. This contract is effective from January 1, 2004 to December 31, 2004. The premium for this contract is \$3.0 million plus an additional premium if a loss is ceded to this contract.

The reinsurance premium for the coverage provided by the \$50 million excess of \$100 million contract was \$6.0 million. This contract expired on December 31, 2003. The Company and CCC entered into a new \$50 million excess of \$100 million contract for the period of January 1, 2004 to December 31, 2004. The premium for this contract is \$6.0 million plus an additional premium if a loss is ceded to this contract.

Effective October 1, 2003, the Company entered into a \$3 million excess of \$12 million excess of loss contract with CCC. The reinsurance premium for the coverage provided by the \$3 million excess of \$12 million contract was \$0.3 million plus, if applicable, additional premiums based on paid losses. The contract provided for aggregate coverage of \$12 million. This contract effectively lowered the Company's net retention per principal for the remainder of 2003 to \$12 million plus a 5% co-participation in the \$45 million layer of excess reinsurance with third party reinsurers. This contract was to expire on December 31, 2004. Effective January 1, 2004, the Company obtained replacement coverage from third party reinsurers as part of the 2004 Excess of Loss Treaty. As of March 31, 2004 and December 31, 2003, CNA Surety had an insurance

Edgar Filing: CNA SURETY CORP - Form 10-Q

receivable balance from CCC and CIC of \$22.4 million and \$71.1 million, respectively. CNA Surety had no reinsurance payables to CCC and CIC as of March 31, 2004 and December 31, 2003.

Large National Contractor

The Company has provided significant surety bond protection guaranteeing projects undertaken by the large national contract principal that is excluded from the Company's third party insurance. The related party reinsurance available to the Company for this principal and the credit extended to the principal by affiliates of the Company are described below.

If the Company should suffer any losses that are discovered prior to September 30, 2005 arising from bonds issued to the contractor with effective dates of September 30, 2002 and prior, the Company would retain the first \$60 million of losses on bonds written, and CCC would incur 100% of losses above \$60 million pursuant to the extended discovery provisions of the two Excess of Loss treaties that expired on September 30, 2002. Any losses discovered after September 30, 2005 on bonds with effective dates prior to September 30, 2002 would be covered up to \$150 million pursuant to the \$50 million excess of \$100 million contract with CCC described above and a twelve month contract with CCC effective January 1, 2004 that provides \$40 million excess of \$60 million reinsurance coverage exclusively for the national contractor.

For bonds that the Company has written after September 30, 2003, in addition to the coverage provided by excess of loss reinsurance treaties described above (\$40 million excess of \$60 million and \$50 million excess of \$100 million) the Company and CCC have entered into facultative reinsurance in connection with larger bonds. The Company's exposure on bonds written from

13

October 1, 2002 through October 31, 2003 was limited to \$20 million per bond. For bonds written between November 1, 2003 and March 31, 2004, the Company's exposure was \$14.7 million. For bonds written subsequent to March 31, 2004, the Company's exposure will be limited to the lesser of \$20 million or 10% of policyholders surplus.

CNAF Credit Facility

In December 2002 and January 2003, CNA Financial Corporation ("CNAF"), parent of CCC, provided loans in an aggregate amount of approximately \$45 million to the national contractor. The loans were provided by CNAF to help the contractor meet its liquidity needs. The loans are evidenced by demand notes and until replaced by the credit facility described below, accrue interest at 10%. In March 2003, CNAF entered into a credit facility with the contractor under which CNAF has agreed to provide up to \$86 million of loans to the contractor and certain of its subsidiaries, including the refinancing of the already advanced \$45 million of credit described above. The credit facility matures in March of 2006. CNAF has been granted a security interest in substantially all of the assets of the contractor to secure borrowings under the new credit facility. Loews Corporation, parent of CNAF, and CNAF have entered into a participation agreement, pursuant to which Loews has purchased a one-third participation share in CNAF's position in the credit facility, on a dollar-for-dollar basis, up to a maximum of \$25 million, plus accrued interest. Although Loews does not have rights against the contractor directly under the participation agreement, it shares recoveries and fees under the facility on a proportional basis with CNAF.

In March 2003, CNAF purchased the contractor's outstanding bank debt for \$16.4 million. The contractor purchased the bank debt and retired it, with \$11.4 million of the purchase price being funded under the new credit facility and \$5

Edgar Filing: CNA SURETY CORP - Form 10-Q

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 outstanding letters of credit issued by the banks for the contractor's benefit. Of these letters of credit, a replacement due to expire in August 2004 remains in the amount of \$3 million. Any CNAF reimbursements for draws upon the banks' letters of credit will become obligations of the contractor to CNAF as draws upon the credit facility. As of March 31, 2004, CNAF had credit exposure of \$64.0 million under the credit facility, net of participation by Loews, in the amount of \$25.7 million, for total outstanding of \$89.7 million. As of April 30, 2004, \$90.0 million was the total outstanding under the credit facility.

As of March 31, 2004, the credit facility was amended to provide for calculating the amount available for borrowing without regard to approximately \$1.1 million representing accrued interest on a bridge loan provided by CNAF that became a borrowing under the facility; the elimination of the reduction in CNAF's commitment upon receipt by the contractor of certain claim proceeds; and an increase in the monthly compensation limits for the contractor's principals. In connection with the amendment, the principals and an affiliate contributed \$5 million in the aggregate to the contractor's capital by forgiving certain of the contractor's indebtedness.

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. 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 the Company believes that the contractor's restructuring efforts will be successful and provide sufficient cash flow for its operations and for repayment of its borrowings, the contractor's failure to achieve its restructuring plan could have a material adverse effect on CNA Surety's future results of operations, cash flow and capital. 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 above should limit the Company's per principal exposure to approximately \$60 million.

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 MONTH
	2004

Reserves at beginning of period:	
Gross.....	\$ 413,539
Ceded reinsurance.....	158,357

Net reserves at beginning of period.....	255,182

Net incurred loss and loss adjustment expenses:	
Provision for insured events of current period.....	20,918
(Decrease) increase in provision for insured events of prior periods....	(287)

Edgar Filing: CNA SURETY CORP - Form 10-Q

Total net incurred.....	20,631

Net payments attributable to:	
Current period events.....	483
Prior period events.....	22,682

Total net payments.....	23,165

Net reserves at end of period.....	252,648
Ceded reinsurance at end of period.....	159,677

Gross reserves at end of period.....	\$ 412,325
	=====

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. The Company paid Chase approximately \$40.7 million and assigned its recovery rights in the Enron bankruptcy to Chase in exchange for a full release of its obligations under the bonds. The Company has no other exposure related to the Enron Corporation. CNA Surety's net loss related to the settlement, after anticipated recoveries under excess of loss reinsurance treaties, was previously fully reserved. Immediately upon execution of the settlement documents, the Company sent written notice for reimbursement to its reinsurers. As of the date of this filing, the Company has billed a total of \$37.1 million to its reinsurers. Five reinsurers responsible for payment of 55% of the treaty proceeds either have paid their portions of the claim or have reached agreement with the Company and paid the Company to commute the entire reinsurance treaty under which the Enron claim was made. Pursuant to the treaty, the Company demanded and began arbitration proceedings against all the reinsurers that have not paid or commuted their treaties. 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 not recorded a reduction with respect to these reinsurance recoverables as of March 31, 2004.

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, as amended September 30, 2003, provides an aggregate of up to \$50 million in borrowings divided between a revolving credit facility (the "Revolving Credit Facility") of \$30 million and a term loan facility (the "Term Loan Facility") of \$20 million. The Revolving Credit Facility matures on September 30, 2005. The Revolving Credit Facility may be increased from time to time by the amount of amortization under the Term Loan Facility up to an additional \$10 million. Such increase is subject to consent by each bank participating in the Revolving Credit Facility, 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 Term Loan Facility. As a result, the current effective interest rate on

Edgar Filing: CNA SURETY CORP - Form 10-Q

the term loan as of March 31, 2004 was 2.76%.

The Term Loan Facility balance was reduced by \$15 million through March 31, 2004 according to the scheduled amortization and payment schedules. Further amortization and payment of the Term Loan Facility will take place at \$10 million per year, in equal semi-annual installments of \$5 million on the following dates:

DATE	AMORTIZATION	OUTSTANDING BALANCE
September 30, 2004.....	5,000,000	10,000,000
March 31, 2005.....	5,000,000	5,000,000
September 30, 2005.....	5,000,000	--

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 Revolving Credit Facility, was 1.30% at March 31, 2004 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 1.15% to 1.45%. The margin on the Term Loan Facility, was 0.625% at March 31, 2004 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 0.48% to 0.80%. As of March 31, 2004, the weighted average interest rate was 2.6% on the \$45 million of outstanding borrowings. As of December 31, 2003, the weighted average interest rate on the 2002 Credit Facility was 2.4% on the \$50 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 Co. 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

15

of 25%, b) minimum net worth of \$350.0 million and c) minimum fixed charge coverage ratio of 2.5 times. Due to the net loss reported for the third quarter of 2003, the Company was in violation of the minimum fixed charge coverage test. The lenders granted the Company a waiver for this violation and amended the 2002 Credit Facility to replace the fixed charge coverage ratio requirement for the next three quarters with a minimum earnings requirement. At March 31, 2004, the Company was in violation of this minimum earnings requirement and has obtained a waiver for this requirement for the current quarter.

6. EMPLOYEE BENEFITS

CNA Surety sponsors a tax deferred savings plan ("401(k) plan") covering substantially all of its employees. Prior to December 31, 1999, the Company matched 70% of the participating employee's contribution up to 6% of eligible compensation (4.2% maximum matching). Effective January 1, 2000, the Company match was increased to 100% of the participating employees contribution up to 3% of eligible compensation and 50% of the participating employees contribution between 3% and 6% of eligible compensation (4.5% maximum matching. Effective January 1, 2004, the Company implemented an additional basic contribution for eligible 401(k) plan participants of 3% (if under age 45) or 5% (if 45 or older) of eligible compensation. In addition, the Company may also make an annual

Edgar Filing: CNA SURETY CORP - Form 10-Q

discretionary performance contribution to the 401(k) plan, subject to the approval of the Company's Board of Directors. The discretionary performance contribution may be restricted by plan and regulatory limitations.

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

Western Surety sponsors two postretirement benefit plans covering certain employees. One plan provides medical benefits, and the other plan provides sick leave termination payments. The postretirement health care plan is contributory and the sick leave plan is non-contributory. Western Surety uses a December 31 measurement date for both of its postretirement benefit plans.

The plans' combined net periodic postretirement benefit cost for the three months ended March 31, 2004 and 2003 included the following components (dollars in thousands):

	MARCH 31, ----- 2004 -----	MARCH 31, ----- 2003 -----
Net periodic benefit cost		
Service cost.....	\$ 42	\$ 41
Interest cost.....	88	71
Prior service cost.....	(37)	(32)
Recognized net actuarial loss/(gain).....	4	(2)
	-----	-----
Net periodic benefit cost.....	\$ 97 =====	\$ 78 =====

The company expects to contribute \$0.3 million to the postretirement benefit plans to pay benefits in 2004.

7. COMMITMENTS AND CONTINGENCIES

At March 31, 2004, the future minimum commitment under operating leases was as follows: 2004 -- \$1.3 million; 2005 -- \$1.5 million; 2006 -- \$1.4 million; 2007 -- \$1.1 million; 2008 -- \$1.0 million; and thereafter -- \$3.7 million.

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.

Edgar Filing: CNA SURETY CORP - Form 10-Q

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 Condensed Consolidated Financial Statements of CNA Surety and notes thereto.

INTRODUCTION

Management believes that the following areas represent the most significant risks and uncertainties impacting the operating performance and financial condition of the Company. The financial impacts of these issues would affect gross and net written premium, incurred losses and reserves for unpaid losses. Each of these issues is discussed in greater detail later in this section.

Availability and cost of reinsurance

Reinsurance coverage is an important component of the Company's capital structure. Reinsurance allows the Company to meet certain regulatory restrictions that would otherwise limit the size of bonds that the Company writes and limit the market segments in which the Company could compete. In addition, reinsurance reduces the potential volatility of earnings and protects the Company's capital by limiting the amount of loss associated with any one bond principal. Due to increased loss frequency and severity for both the Company and within the surety industry in general that began emerging in 1999, the Company, beginning in 2002, paid substantially higher reinsurance premiums and was required to retain higher amounts of its per principal exposure. Through aggressive exposure reduction efforts and continued underwriting discipline, the Company has been able to purchase additional limits and more expansive reinsurance protection for 2003 and 2004 as compared to 2002.

Exposure to loss on principals excluded from reinsurance programs

Beginning in 2002, the Company's reinsurers excluded certain accounts (for which the Company had continuing exposure from bonds written in prior years) from the reinsurance programs. For these accounts, the company would retain up to \$60 million of loss. Due to the improved financial condition of some of these accounts and the Company's efforts to have these accounts covered, two of these accounts are again covered under the Company's 2004 reinsurance program. However, the Company's reinsurance program for 2004 does exclude three principals. Of these excluded principals, one is a foreign industrial enterprise, one is a domestic electric utility and the other is a large national contractor. As of March 31, 2004, Management estimates that the Company's net exposure to these accounts would be \$13 million, \$46 million and \$60 million, respectively. The foreign industrial enterprise and the electric utility are discussed on page 23, and the large national contractor is discussed in detail on page 25. As of March 31, 2004, no material loss event has occurred with respect to these three principals.

Financial strength ratings

Surety bond principals and obligees often refer to the financial strength ratings assigned by A.M. Best Co. ("A.M. Best"), Standard and Poor's ("S&P") and other similar companies when they are choosing a surety company. Because the Company uses the underwriting capacity of Continental Casualty Company ("CCC") and its subsidiaries to serve larger accounts, the insurer financial strength rating of both the Company and CCC factor into customers' decisions. After reporting a significant operating loss in the third quarter of 2003, the Company's A.M. Best rating was lowered from A+ to A with a negative outlook. CCC

Edgar Filing: CNA SURETY CORP - Form 10-Q

also reported a significant operating loss in the third quarter of 2003, but A.M. Best affirmed CCC's rating of A with a negative outlook. Management believes that the current ratings are sufficient for the Company to conduct all aspects of its business. Management also believes that a one level reduction in ratings would have only a minimal impact on operations. A further decrease beyond one level would likely have a material adverse impact on the Company's ability to write business. Management believes that the likelihood of further ratings downgrades has been reduced by ongoing efforts to reduce large exposures and the lower per principal retentions under the 2004 reinsurance program.

17

Economic Conditions

The Company's results are impacted by general corporate credit conditions, as well as by the condition of the public construction segment of the economy. While corporate credit default rates appear to be improving from recent historically high levels, the amount of new public construction spending appears to be slowing. An improvement in overall corporate default rates could be expected to have a favorable impact on the Company's loss costs. A slow down in public construction spending could be expected to put pressure on the Company's written premium production and also adversely impact loss costs. Management believes that the diversification of the Company's book of business, with approximately 43% of current written premium from products that are less sensitive to economic conditions, mitigates the impact of these economic factors.

Bond Premium Rates

The premium rates that the Company charges for its bonds have a direct impact on the amount of revenue generated and on the ratio of incurred losses to earned premium. Over the last several years, the Company has charged higher rates for its bonds, particularly in the large commercial and contract segments. These two segments demonstrated the greater rate need due to the emergence of increased loss frequency and severity as noted above. While the Company will continue to aggressively pursue rate increases where indicated, competitive factors appear to be pointing to a decreased ability to achieve the level of rate increases that have been obtained over the past several years, particularly in the small and middle market contract segments.

CRITICAL ACCOUNTING POLICIES

Management believes the most significant accounting policies and related disclosures for purposes of understanding the Company's results of operations and financial condition pertain to reserves for unpaid losses and loss adjustment expenses and reinsurance, investments, deferred acquisition costs, and goodwill and other intangible assets. 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.

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,

Edgar Filing: CNA SURETY CORP - Form 10-Q

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 Condensed Consolidated Balance Sheet includes estimated liabilities for unpaid losses and loss adjustment expenses of \$412.3 million and reinsurance receivables related to losses of \$159.7 million at March 31, 2004. While many factors impact these estimates, Management believes that past changes in the Company's business mix and reinsurance program along with increased corporate default rates were the primary drivers of the need to substantially increase reserve levels in 2003. Beginning in the late 1990's, the Company began writing more bonds for large corporate clients. Shortly thereafter, corporate default rates increased

18

dramatically. These exposures proved to be more volatile than the Company's more traditional contract and small commercial surety products, and began resulting in a higher frequency of severe losses. As a result, the Company's reinsurers significantly increased rates, reduced the amount of coverage available to the Company and excluded certain accounts from the reinsurance program. For 2002, the Company's per principal retention increased from \$5 million to \$20 million. Although the Company reduced its per principal retention to \$15 million for 2003, these higher retentions, at a time of continuing higher frequency of severe losses, further increased the volatility of results.

Since 2001, the Company has been aggressively reducing its exposures to large corporate clients. Management believes that these efforts, along with continued underwriting discipline in its traditional contract and small commercial products, have been key to further reducing the Company's per principal retention for most accounts to \$10 million for the 2004 reinsurance program. Management anticipates that these steps will reduce the volatility of the Company's results.

Due to the inherent uncertainties in the process of establishing the liabilities for unpaid losses and loss adjustment expenses, the actual ultimate claims amounts will differ from the currently recorded amounts. This difference could have a material effect on reported earnings. For example, a 10% increase in the March 31, 2004 net estimate for unpaid losses and loss adjustment expenses would produce a charge to pre-tax earnings of approximately \$25.3 million. Future effects from changes in these estimates will be recorded as a

Edgar Filing: CNA SURETY CORP - Form 10-Q

component of losses incurred in the period such changes are determined to be needed.

Investments

Management believes the Company has the ability to hold all fixed income securities to maturity. However, the Company may dispose of securities prior to their scheduled maturity due to changes in interest rates, prepayments, tax and credit considerations, liquidity or regulatory capital requirements, or other similar factors. As a result, the Company 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. Invested assets are exposed to various risks, such as interest rate risk, market risk and credit risk. Due to the level of risk associated with invested assets and the level of uncertainty related to changes in the value of these assets, it is possible that changes in risks in the near term may significantly affect the amounts reported in the Condensed Consolidated Balance Sheets and Consolidated Statements of Income.

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

Edgar Filing: CNA SURETY CORP - Form 10-Q

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.

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

The Company's corporate objective is to be the leading provider of surety and surety-related products in the United States and in select international markets and to be the surety of choice for its customers and independent agents and brokers.

Western Surety is currently rated A (Excellent) with a negative rating outlook, by A.M. Best. An A (Excellent) rating is assigned to those companies which A.M. Best believes have an excellent ability to meet their ongoing obligations to policyholders. A (Excellent) rated insurers have been shown to be among the strongest in ability to meet policyholder and other contractual obligations. The rating outlook indicates the potential direction of a company's rating for an intermediate period, generally defined as the next 12 to 36 months. 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.

Edgar Filing: CNA SURETY CORP - Form 10-Q

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.

RESULTS OF OPERATIONS

Financial Measures

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

20

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

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

Edgar Filing: CNA SURETY CORP - Form 10-Q

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

COMPARISON OF CNA SURETY RESULTS FOR THE THREE MONTHS ENDED MARCH 31, 2004 AND 2003

Analysis of Net Income

The Company had net income of \$6.4 million for the three months ended March 31, 2004, as compared to \$11.0 million for the comparable period in the prior year. The decrease in net income from period to period reflects increased underwriting expenses that included \$1.7 million of severance costs related to the re-organization of the company's field office structure. Expenses also include a \$4.9 million increase in the accrual for policyholder dividends primarily related to premiums earned in 2002 and prior. These higher expenses were partially offset by higher net investment gains.

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

Results of Insurance Operations

Underwriting components for the Company for the three months ended March 31, 2004 and 2003 are summarized in the following table (dollars in thousands):

	THREE MONTHS ENDED MARCH 31, 2004	2003
	-----	-----
Gross written premiums.....	\$ 95,879	\$ 91,671
	=====	=====
Net written premiums.....	\$ 71,554	\$ 79,334
	=====	=====
Net earned premiums.....	\$ 75,197	\$ 71,206
	=====	=====
Net losses and loss adjustment expenses.....	\$ 20,631	\$ 18,606
	=====	=====
Net commissions, brokerage and other expenses.....	\$ 55,312	\$ 44,296
	=====	=====
Loss ratio.....	27.4%	26.1%
Expense ratio.....	73.6	62.2
	-----	-----
Combined ratio.....	101.0%	88.3%
	=====	=====

Premiums Written

CNA Surety primarily markets contract and commercial surety bonds.

Edgar Filing: CNA SURETY CORP - Form 10-Q

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 MARCH 31,	
	2004	2003
	-----	-----
Contract.....	\$ 49,787	\$ 41,623
Commercial.....	37,331	42,015
Fidelity and other.....	8,761	8,033
	-----	-----
	\$ 95,879	\$ 91,671
	=====	=====

Gross written premiums increased 4.6%, or \$4.2 million, for the three months ended March 31, 2004 over the comparable period in 2003. Contract surety increased 19.6%, or \$8.2 million, as compared to 2003, reflecting improving rates. Commercial surety decreased 11.1 percent to \$37.3 million as continued strong volume growth in small commercial products was more than offset by the results of ongoing efforts to reduce aggregate exposures to large commercial accounts. The estimated impact of the Company's exposure reduction efforts to date represents approximately \$24 million in annual premium, assuming an average rate per \$1,000 of bond exposure of \$3.46, or 35 basis points, and approximately \$6.8 billion of bond exposure. Fidelity and other products increased 9.1%, or \$0.7 million, to \$8.8 million for the three months ended March 31, 2004 as compared to the same period in 2003 due primarily to an increase in fidelity business.

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

	THREE MONTHS ENDED MARCH 31,	
	2004	2003
	-----	-----
Contract.....	\$ 33,903	\$ 36,133
Commercial.....	29,269	35,523
Fidelity and other.....	8,382	7,678
	-----	-----
	\$ 71,554	\$ 79,334
	=====	=====

For the three months ended March 31, 2004, net written premiums decreased 9.8%, or \$7.8 million, to \$71.6 million as compared to the same period in 2003, reflecting the Company's decision to purchase additional reinsurance protection

Edgar Filing: CNA SURETY CORP - Form 10-Q

as well as the timing of reinsurance premium payments. Ceded written premiums increased \$12.0 million to \$24.3 million for the first quarter of 2004 compared to the same period of last year primarily due to the aforementioned changes in the Company's reinsurance programs. Net written premiums for contract surety business decreased 6.2%, or \$2.2 million, to \$33.9 million for the three months ended March 31, 2004. Net written premiums for commercial surety decreased 17.6%, or \$6.3 million, to \$29.3 million. Fidelity and other products increased 9.2%, or \$0.7 million, to \$8.4 million for the three months ended March 31, 2004 as compared to the same period in 2003.

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.

22

2004 Third Party Reinsurance Compared to 2003 Third Party Reinsurance

Effective January 1, 2004, CNA Surety entered into a new excess of loss treaty ("2004 Excess of Loss Treaty") with a group of third party reinsurers that reduced its net retention per principal to \$10 million with a 5% co-participation in the \$90 million layer of third party reinsurance coverage above the Company's retention. This new excess of loss treaty replaces the \$45 million excess of \$15 million per principal coverage, as well as the \$40 million excess of \$60 per principal and the \$3 million excess of \$12 million coverage that had been provided by CCC. The significant differences between the new excess of loss reinsurance program and the Company's 2003 Excess of Loss Treaty are as follows. The annual aggregate coverage increases from \$110 million in 2003 to \$157 million in 2004. The minimum annual premium for the 2004 excess of loss treaty is \$49.2 million (net of expected return premium) compared to a total of \$42.0 million of reinsurance premiums paid in 2003 (net of expected return premium) for the \$45 million excess of \$15 million, the \$40 million excess of \$60 million and the \$3 million excess of \$12 million treaties. The contract also includes an optional twelve month extended discovery period, for an additional premium, which will provide coverage for losses discovered in 2005 on bonds that were in force during 2004, and somewhat less restrictive special acceptance provisions for larger contract accounts than those contained in the 2003 Excess of Loss Treaty.

In addition to the one large contract principal (described later) and the two commercial principals excluded (based upon class of business), the Company's reinsurers had 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 \$46 million and is currently rated B- by Standard and Poor's ("S&P"). The bonded exposure will decline over the term of the bond which extends until 2007. The other is a foreign industrial enterprise with an estimated bonded exposure of \$13 million. The remaining exposure is expected to be discharged by June 30, 2004.

Each of the four contract principals continues to perform their contractual obligations underlying the Company's surety bonds.

With respect to the three contract principals other than the large

Edgar Filing: CNA SURETY CORP - Form 10-Q

national contractor, two contract principals have completed asset sales and other reorganization efforts and have been accepted into the 2004 Excess of Loss Treaty. The one large contract principal and the two commercial principals remain excluded from the 2004 Excess of Loss Treaty.

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 of these agreements originally were entered into on September 30, 1997 (the "Merger Date"): (i) the Surety Quota Share Treaty (the "Quota Share Treaty"); (ii) the Aggregate Stop Loss Reinsurance Contract (the "Stop Loss Contract"); and (iii) the Surety Excess of Loss Reinsurance Contract (the "Excess of Loss Contract"). All of these contracts have expired. Some have been renewed on different terms as described below.

The Services and Indemnity Agreement provides the Company's insurance subsidiaries with the authority to perform various administrative, management, underwriting and claim functions in order to conduct the business of CCC and CIC and to be reimbursed by CCC for services rendered. In consideration for providing the foregoing services, CCC has agreed to pay Western Surety a quarterly fee of \$50,000. This agreement was renewed on January 1, 2004 and expires on December 31, 2004 and is annually renewable thereafter. There was no amount due to the CNA Surety insurance subsidiaries as of March 31, 2004.

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.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of September 30, 1997 by agreeing to pay Western Surety, within 30 days following the end of each calendar quarter, the amount of any adverse development on such reserves, as re-estimated as of the end of such calendar quarter. There was no adverse reserve development for the period from September 30, 1997 (date of inception) through March 31, 2004.

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. The Quota Share Treaty was again renewed on January 1, 2004 on substantially the same terms with an expiration date of December 31, 2004; 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%

23

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

Edgar Filing: CNA SURETY CORP - Form 10-Q

ratio exceeds 24% in any of the accident years 1997 through 2000 on certain insured accounts (the "Loss Ratio Cap"), the Stop Loss Contract requires CCC at the end of each calendar quarter following the Merger Date, to pay to the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which 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 March 31, 2004, the Company had billed and received \$54.9 million under the Stop Loss Contract.

The Excess of Loss Contract 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 provided \$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 provided 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 for new 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.

Effective January 1, 2004, the Company obtained replacement coverage from third party reinsurers as part of the 2004 Excess of Loss Treaty. Accordingly, the \$40 million excess of \$60 million contract with CCC was commuted effective January 1, 2004. As part of this commutation, the Company has received a commutation payment of \$10.9 million from CCC. As of December 31, 2003 the full amount of the commutation payment had been recognized as a receivable. The Company and CCC entered into a new \$40 million excess of \$60 million reinsurance contract providing coverage exclusively for the one large national contractor that is excluded from the Company's third party reinsurance. This contract is effective from January 1, 2004 to December 31, 2004. The premium for this contract is \$3.0 million plus an additional premium if a loss is ceded to this contract.

The reinsurance premium for the coverage provided by the \$50 million excess of \$100 million contract was \$6.0 million. This contract expired on December 31, 2003. The Company and CCC entered into a new \$50 million excess of

Edgar Filing: CNA SURETY CORP - Form 10-Q

\$100 million contract for the period of January 1, 2004 to December 31, 2004. The premium for this contract is \$6.0 million plus an additional premium if a loss is ceded to this contract.

Effective October 1, 2003, the Company entered into a \$3 million excess of \$12 million excess of loss contract with CCC. The reinsurance premium for the coverage provided by the \$3 million excess of \$12 million contract was \$0.3 million plus, if applicable, additional premiums based on paid losses. The contract provided for aggregate coverage of \$12 million. This contract effectively lowered the Company's net retention per principal for the remainder of 2003 to \$12 million plus a 5% co-participation in the \$45 million layer of excess reinsurance with third party reinsurers. This contract was to expire on December 31, 2004. Effective January 1, 2004, the Company obtained replacement coverage from third party reinsurers as part of the 2004 Excess of Loss Treaty. As of March 31, 2004 and March 31, 2003, CNA Surety had an insurance receivable balance from CCC and CIC of \$22.4 million and \$71.1 million, respectively. CNA Surety had no reinsurance payables to CCC and CIC as of March 31, 2004 and December 31, 2003.

24

Large National Contractor

The Company has provided significant surety bond protection guaranteeing projects undertaken by the large national contract principal that is excluded from the Company's third party insurance. The related party reinsurance available to the Company for this principal and the credit extended to the principal by affiliates of the Company are described below.

If the Company should suffer any losses that are discovered prior to September 30, 2005 arising from bonds issued to the contractor with effective dates of September 30, 2002 and prior, the Company would retain the first \$60 million of losses on bonds written, and CCC would incur 100% of losses above \$60 million pursuant to the extended discovery provisions of the two Excess of Loss treaties that expired on September 30, 2002. Any losses discovered after September 30, 2005 on bonds with effective dates prior to September 30, 2002 would be covered up to \$150 million pursuant to the \$50 million excess of \$100 million contract with CCC described above and a twelve month contract with CCC effective January 1, 2004 that provides \$40 million excess of \$60 million reinsurance coverage exclusively for the national contractor.

For bonds that the Company has written after September 30, 2003, in addition to the coverage provided by excess of loss reinsurance treaties described above (\$40 million excess of \$60 million and \$50 million excess of \$100 million) the Company and CCC have entered into facultative reinsurance in connection with larger bonds. The Company's exposure on bonds written from October 1, 2002 through October 31, 2003 was limited to \$20 million per bond. For bonds written between November 1, 2003 and March 31, 2004, the Company's exposure was \$14.7 million. For bonds written subsequent to March 31, 2004, the Company's exposure will be limited to the lesser of \$20 million or 10% of policyholders surplus.

The Company believes the run-off protection provided by the extended discovery provisions of the expired agreements, the current protection provided by the \$40 million excess of \$60 million and the \$50 million excess of \$100 million treaties, and the facultative reinsurance provided for larger bonds written after September 30, 2002, should limit the Company's exposure for bonds written on behalf of the national contractor to \$60 million.

CNAF Credit Facility

Edgar Filing: CNA SURETY CORP - Form 10-Q

In December 2002 and January 2003, CNAF, parent of CCC, provided loans in an aggregate amount of approximately \$45 million to the national contractor. The loans were provided by CNAF to help the contractor meet its liquidity needs. The loans are evidenced by demand notes and until replaced by the credit facility described below, accrue interest at 10%. In March 2003, CNAF entered into a credit facility with the contractor under which CNAF has agreed to provide up to \$86 million of loans to the contractor and certain of its subsidiaries, including the refinancing of the already advanced \$45 million of credit described above. The credit facility matures in March of 2006. CNAF has been granted a security interest in substantially all of the assets of the contractor to secure borrowings under the new credit facility. Loews, parent of CNAF, and CNAF have entered into a participation agreement, pursuant to which Loews has purchased a one-third participation share in CNAF's position in the credit facility, on a dollar-for-dollar basis, up to a maximum of \$25 million, plus accrued interest. Although Loews does not have rights against the contractor directly under the participation agreement, it shares recoveries and fees under the facility on a proportional basis with CNAF.

In March 2003, CNAF purchased the contractor's outstanding bank debt for \$16.4 million. The contractor purchased the bank debt and retired it, with \$11.4 million of the purchase price 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 outstanding letters of credit issued by the banks for the contractor's benefit. Of these letters of credit, a replacement due to expire in August 2004 remains in the amount of \$3 million. Any CNAF reimbursements for draws upon the banks' letters of credit will become obligations of the contractor to CNAF as draws upon the credit facility. As of March 31, 2004, CNAF had credit exposure of \$64.0 million under the credit facility, net of participation by Loews, in the amount of \$25.7 million, for total outstanding of \$89.7 million. As of April 30, 2004, \$90.0 million was the total outstanding under the credit facility.

As of March 31, 2004, the credit facility was amended to provide for calculating the amount available for borrowing without regard to approximately \$1.1 million representing accrued interest on a bridge loan provided by CNAF that became a borrowing under the facility; the elimination of the reduction in CNAF's commitment upon receipt by the contractor of certain claim proceeds; and an increase in the monthly compensation limits for the contractor's principals. In connection with the amendment, the principals and an affiliate contributed \$5 million in the aggregate to the contractor's capital by forgiving certain of the contractor's indebtedness.

25

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. 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 the Company believes that the contractor's restructuring efforts will be successful and provide sufficient cash flow for its operations and for repayment of its borrowings, the contractor's failure to achieve its restructuring plan could have a material adverse effect on CNA Surety's future results of operations, cash flow and capital. 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 above should limit the

Edgar Filing: CNA SURETY CORP - Form 10-Q

Company's per principal exposure to approximately \$60 million.

Net Loss Ratio

The net loss ratios for the three months ended March 31, 2004 and 2003 were 27.4% and 26.1%, respectively. The 2004 loss ratio included \$0.3 million of net favorable loss reserve development related to prior years for the three months ended March 31, 2004. The increase in the loss ratio in 2004 reflects indications of a higher base line loss ratio resulting from the actuarial reviews performed during 2003.

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. The Company paid Chase approximately \$40.7 million and assigned its recovery rights in the Enron bankruptcy to Chase in exchange for a full release of its obligations under the bonds. The Company has no other exposure related to the Enron Corporation. CNA Surety's net loss related to the settlement, after anticipated recoveries under excess of loss reinsurance treaties, was previously fully reserved. Immediately upon execution of the settlement documents, the Company sent written notice for reimbursement to its reinsurers. As of the date of this filing, the Company has billed a total of \$37.1 million to its reinsurers. Five reinsurers responsible for payment of 55% of the treaty proceeds either have paid their portions of the claim or have reached agreement with the Company and have paid the Company to commute the entire reinsurance treaty under which the Enron claim was made. Pursuant to the treaty, the Company demanded and began arbitration proceedings against 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 not recorded a reduction with respect to these reinsurance recoverables as of March 31, 2004.

Expense Ratio

The expense ratio increased to 73.6% for the three months ended March 31, 2004 compared to 62.2% for the same period in 2003. The expense ratio for the first quarter of 2004 was negatively impacted by 6.5 percentage points due to the increase in the accrual for policyholder dividends on certain contract surety business. This increase resulted from the implementation of an improved methodology for estimating the ultimate dividend obligation on premiums that have been earned to date. This dividend obligation is related to contract surety bonds written in the state of Texas. The increase in the accrual primarily relates to premiums earned prior to 2003. The expense ratio was further impacted by 2.3 percentage points related to the initiative to simplify and streamline the field organization.

Exposure Management

The Company's business is subject to certain risks and uncertainties associated with the current economic environment and corporate credit conditions. In response to these risks and uncertainties, the Company has 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 16.6% in 2004 on large commercial accounts, which are defined as accounts with exposures in excess of \$10 million:

Edgar Filing: CNA SURETY CORP - Form 10-Q

COMMERCIAL ACCOUNT EXPOSURE	NUMBER OF ACCOUNTS AS OF		TOTAL EXPOSURE (DOLLARS IN BILLIONS) AS OF		
	MARCH 31, 2004	DECEMBER 31, 2003	MARCH 31, 2004	DECEMBER 31, 2003	% REDUCTION
\$100 million and larger	4	7	\$ 0.5	\$ 0.9	44.4%
\$50 to \$100 million	10	8	0.7	0.6	(16.7)%
\$25 to \$50 million	13	13	0.5	0.5	--
\$10 to \$25 million	52	66	0.8	1.0	20.0%
	--	--	-----	-----	
Total	79	94	\$ 2.5	\$ 3.0	16.7%
	==	==	=====	=====	

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.

Investment Income

For the three months ended March 31, 2004, net investment income was \$7.0 million compared to the three months ended March 31, 2003 of \$6.7 million. The increase in investment income primarily reflects the increase in invested assets over the four quarters. The annualized pretax yields were 4.4% and 4.7% for the three months ended March 31, 2004 and 2003, respectively. The annualized after-tax yields were 3.6% and 3.9% for the three months ended March 31, 2004 and 2003.

Net realized investment gains were approximately \$2.2 million for the three months ended March 31, 2004 compared to approximately \$0.7 million for the same period in 2003.

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

	THREE MONTHS ENDED MARCH 31,	
	2004	2003
Gross realized investment gains.....	\$ 2,234	\$ 1,261
Gross realized investment losses.....	(4)	(531)
	-----	-----
Net realized investment gains.....	\$ 2,230	\$ 730
	=====	=====

The Company's investment portfolio generally is managed to maximize after-tax investment return, while minimizing credit risk with investments concentrated in high quality income securities. CNA Surety's portfolio is

Edgar Filing: CNA SURETY CORP - Form 10-Q

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.

Analysis of Other Operations

Interest expense for the three months ended March 31, 2004 decreased slightly, as compared to the first quarter in 2003, due to lower outstanding debt. Average debt outstanding was \$50.4 million for the first quarter of 2004 compared to \$60.8 million in the first quarter of 2003. The weighted average interest rate for the three months ended March 31, 2004 was 2.7% compared to 2.3% for the same period in 2003.

Income Taxes

Income tax expense was \$1.7 million and \$4.4 million and the effective income tax rates were 21.5% and 28.6% for the three

27

months ended March 31, 2004 and 2003, respectively. The decrease in the estimated effective tax rate in first quarter 2004 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 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 March 31, 2004, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of \$639.7 million of fixed income securities, \$2.2 million of equities, \$27.7 million of short-term investments, \$1.1 million of other investments and \$3.0 million of cash. At December 31, 2003, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of \$573.7 million of fixed income securities, \$49.8 million of short-term investments, \$1.1 million of other investments and \$2.0 million of

Edgar Filing: CNA SURETY CORP - Form 10-Q

cash.

Cash flow at the parent company level is derived principally from dividend and tax sharing payments from its insurance subsidiaries. The principal obligations at the parent company level are to service debt, pay operating expenses, including income taxes, and pay dividends to stockholders. At March 31, 2004, the parent company's invested assets consisted of \$6.1 million of fixed income securities, \$1.0 million of equity securities, \$11.4 million of short-term investments and \$2.0 million of cash. At December 31, 2003, the parent company's invested assets consisted of \$6.3 million of fixed income securities, \$1.1 million of equity securities, \$14.1 million of short-term investments and \$6.0 million of cash. At both March 31, 2004 and December 31, 2003, parent company short-term investments and cash included \$6.6 million of restricted cash related to premium receipt collections ultimately due to the Company's insurance subsidiaries.

The Company's consolidated net cash flow provided by operating activities was \$42.9 million for the three months ended March 31, 2004 compared to net cash flow used by operating activities of \$35.1 million for the comparable period in 2003. The increase in net cash flow provided by operating activities primarily relates to a decrease in reinsurance receivables and a decrease in the amount of loss payments.

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, as amended September 30, 2003, provides an aggregate of up to \$50 million in borrowings divided between a revolving credit facility (the "Revolving Credit Facility") of \$30 million and a term loan facility (the "Term Loan Facility") of \$20 million. The Revolving Credit Facility matures on September 30, 2005. The Revolving Credit Facility may be increased from time to time by the amount of amortization under the Term Loan facility up to an additional \$10 million. Such increase is subject to consent by each bank participating in the Revolving Credit Facility, 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 Term Loan Facility. As a result, the current effective interest rate on the term loan as of March 31, 2004 was 2.76%.

The Term Loan Facility balance was reduced by \$15 million through March 31, 2004 according to the scheduled amortization and payment schedules. Further amortization and payment of the Term Loan Facility will take place at \$10 million per year, in equal semi-annual installments of \$5 million on the following dates:

DATE	AMORTIZATION	OUTSTANDING BALANCE
September 30, 2004.....	5,000,000	10,000,000
March 31, 2005.....	5,000,000	5,000,000
September 30, 2005.....	5,000,000	--

The interest rate on borrowings under the 2002 Credit Facility may be fixed, at CNA Surety's option, for a period of one, two,

Edgar Filing: CNA SURETY CORP - Form 10-Q

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 Revolving Credit Facility, was 1.30% at March 31, 2004 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 1.15% to 1.45%. The margin on the Term Loan Facility, was 0.625% at March 31, 2004 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 0.48% to 0.80%. As of March 31, 2004, the weighted average interest rate was 2.6% on the \$45 million of outstanding borrowings. As of December 31, 2003, the weighted average interest rate on the 2002 Credit Facility was 2.4% on the \$50 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 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. Due to the net loss reported for the third quarter of 2003, the Company was in violation of the minimum fixed charge coverage test. The lenders granted the Company a waiver for this violation and amended the 2002 Credit Facility to replace the fixed charge coverage ratio requirement for the next three quarters with a minimum earnings requirement. At March 31, 2004, the Company was in violation of this minimum earnings requirement and has received a waiver for this requirement for the current quarter.

In 1999 CNA Surety acquired certain assets of Clark Bonding Company, Inc., a Charlotte, North Carolina, insurance agency and brokerage doing business as The Bond Exchange for \$5.9 million. As part of this acquisition, the Company incurred an additional \$1.9 million of debt in the form of a promissory note. The promissory note matures on July 27, 2004 and has an interest rate of 5.0%. The balance of this promissory note at March 31, 2004 was \$0.4 million.

On April 30, 2004, the Company committed to issue \$30 million of trust preferred securities through two pooled transactions. These securities have a thirty-year term and are callable by the Company after five years. Subject to the funding of the pooled transactions as anticipated, the Company expects to finalize these transactions in May of 2004. The Company is currently evaluating the potential uses of these additional funds including, among others, reducing outstanding debt and contributing capital to the Company's insurance subsidiaries.

A summary of the Company's commitments as of March 31, 2004 is presented in the following table:

COMMITMENTS

MARCH 31, 2004	2004	2005	2006	2007	2008	THEREA
-----	-----	-----	-----	-----	-----	-----
	(IN MILLIONS)					
Debt.....	\$ 5.4	\$ 40.0	\$ --	\$ --	\$ --	\$
Operating leases.....	1.3	1.5	1.4	1.1	1.0	
Other long-term liabilities (a)...	1.0	1.7	0.4	0.4	0.5	
	-----	-----	-----	-----	-----	-----
Total.....	\$ 7.7	\$ 43.2	\$ 1.8	\$ 1.5	\$ 1.5	\$
	=====	=====	=====	=====	=====	=====

(a) reflects post-employment obligations to former executives and

Edgar Filing: CNA SURETY CORP - Form 10-Q

unfunded post-retirement benefit plans

As an insurance holding company, CNA Surety is dependent upon dividends and other permitted payments from its insurance subsidiaries to pay operating expenses, meet debt service requirements, as well as to pay cash dividends. The payment of dividends by the insurance subsidiaries is subject to varying degrees of supervision by the insurance regulatory authorities in South Dakota and Texas. In South Dakota, where Western Surety and 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 2004 is based on statutory surplus and income at and for the year ended December 31, 2003. Without prior regulatory approval in 2004, CNA Surety's insurance subsidiaries may pay stockholder dividends of \$19.0 million in the aggregate. CNA Surety did not receive a dividend from its

29

insurance subsidiaries during the first three months of 2004 or during the first three months of 2003.

Combined statutory surplus totaled \$200.4 million at March 31, 2004, resulting in a net written premium to statutory surplus ratio of 1.6 to 1. Insurance regulations restrict Western Surety's maximum net retention on a single surety bond to 10 percent of statutory surplus. Under the 2004 Excess of Loss Treaty, the Company's net retention on new bonds would generally be \$10 million plus a 5% co-participation in the \$90 million layer of excess reinsurance above the Company's retention and this regulation would require minimum statutory surplus of \$145.0 million at Western Surety. This surplus constraint may limit the amount of future dividends Western Surety could otherwise pay to CNA Surety.

In accordance with the provisions of intercompany tax sharing agreements between CNA Surety and its subsidiaries, the tax of each subsidiary shall be determined based upon each subsidiary's separate return liability. Intercompany tax payments are made at such times as estimated tax payments would be required by the Internal Revenue Service ("IRS"). CNA Surety did not receive any tax sharing payments from its subsidiaries for the three months ended March 31, 2004 and 2003, respectively.

Western Surety and SBCA each qualify as an acceptable surety for federal and other public works project bonds pursuant to U.S. Department of Treasury regulations. U.S. Treasury underwriting limitations are based on an insurer's statutory surplus. Effective July 1, 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

Edgar Filing: CNA SURETY CORP - Form 10-Q

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.

FINANCIAL CONDITION

Investment Portfolio

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

MARCH 31, 2004	AMORTIZED COST OR COST	GROSS UNREALIZED GAINS	GROSS LESS THAN MONTH
Fixed income securities:			
U.S. Treasury securities and obligations of U.S. Government and agencies:			
U.S. Treasury	\$ 21,234	\$ 883	\$
U.S. Agencies	4,585	112	
Collateralized mortgage obligations	10,042	1	
Mortgage pass-through securities	48,090	624	
Obligations of states and political subdivisions	385,136	27,689	
Corporate bonds	109,869	7,009	
Non-agency collateralized mortgage obligations	8,516	549	
Other asset-backed securities:			
Second mortgages/home equity loans	5,389	470	
Credit card receivables	5,000	35	
Other	4,548	321	
Redeemable preferred stock	5,356	874	
Total fixed income securities	607,765	38,567	
Equity securities	3,041	200	
Total	\$ 610,806	\$ 38,767	\$

The following table summarizes for fixed maturities in an unrealized loss position at March 31, 2004, the aggregate fair value and gross unrealized loss by length of time those securities have been continuously in an unrealized loss position (dollars in thousands):

Edgar Filing: CNA SURETY CORP - Form 10-Q

MARCH 31, 2004		
UNREALIZED LOSS AGING	ESTIMATED FAIR VALUE	GROSS UNREALIZED LOSS
Fixed maturity securities:		
Investment grade:		
0-12 months.....	\$ 35,478	\$ 459
Greater than 12 months.....	1,820	44
Total investment grade.....	\$ 37,298	\$ 503

A significant judgment in the valuation of investments is the determination of when an other-than-temporary decline in value has occurred. The Company follows a consistent and systematic process for impairing securities that sustain other-than-temporary declines in value. The Company has established a watch list that is reviewed by the Chief Financial Officer and two other executive officers on at least a quarterly basis. The watch list includes individual securities that fall below certain thresholds or that exhibit evidence of impairment indicators including, but not limited to, a significant adverse change in the financial condition and near term prospects of the investment or a significant adverse change in legal factors, the business climate or credit ratings.

When a security is placed on the watch list, it is monitored for further market value changes and additional news related to the issuer's financial condition. The focus is on objective evidence that may influence the evaluation of impairment factors.

The decision to record an impairment loss incorporates both quantitative criteria and qualitative information. The Company considers a number of factors including, but not limited to: (a) the length of time and the extent to which the market value has been less than book value, (b) the financial condition and near term prospects of the issuer, (c) the intent and ability of the Company to retain its investment for a period of time sufficient to allow for any anticipated recovery in value, (d) whether the debtor is current on interest and principal payments and (e) general market conditions and industry or sector specific factors.

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

As of March 31, 2004 and December 31, 2003, the Company had no impaired securities.

FORWARD-LOOKING STATEMENTS

This report includes a number of statements which relate to anticipated future events (forward-looking statements) rather than actual present conditions or historical events. Forward-looking statements generally include words such as "believes," "expects," "intends," "anticipates," "estimates," and similar expressions. Forward-looking statements in this report include expected developments in the Company's insurance business, including losses and loss reserves; the impact of routine ongoing insurance reserve reviews being conducted by the Company; the routine state regulatory examinations of the Company's primary insurance company subsidiaries, and the Company's responses to

Edgar Filing: CNA SURETY CORP - Form 10-Q

the results of those reviews and examinations; the Company's expectations concerning its revenues, earnings, expenses and investment activities; expected cost savings and other results from the Company's expense reduction and restructuring activities; and the Company's proposed actions in response to trends in its business.

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

- general economic and business conditions;
- changes in financial markets such as fluctuations in interest rates, long-term periods of low interest rates, credit conditions

31

and currency, commodity and stock prices;

- the effects of corporate bankruptcies, such as Enron and WorldCom, on surety bond claims, as well as on capital markets;
- changes in foreign or domestic political, social and economic conditions;
- regulatory initiatives and compliance with governmental regulations, judicial decisions, including interpretation of policy provisions, decisions regarding coverage, trends in litigation and the outcome of any litigation involving the Company, and rulings and changes in tax laws and regulations;
- regulatory limitations, impositions and restrictions upon the Company, including the effects of assessments and other surcharges for guaranty funds and other mandatory pooling arrangements;
- the impact of competitive products, policies and pricing and the competitive environment in which the Company operates, including changes in the Company's books of business;
- product and policy availability and demand and market responses, including the level of ability to obtain rate increases and decline or non-renew underpriced accounts, to achieve premium targets and profitability and to realize growth and retention estimates;
- development of claims and the impact on loss reserves, including changes in claim settlement practices;
- the performance of reinsurance companies under reinsurance contracts with the Company;
- results of financing efforts, including the availability of bank credit facilities;
- the sufficiency of the Company's loss reserves and the possibility of future increases in reserves;
- the risks and uncertainties associated with the Company's loss reserves; and,

Edgar Filing: CNA SURETY CORP - Form 10-Q

- the possibility of further changes in the Company's ratings by ratings agencies, including the inability to access certain markets or distribution channels and the required collateralization of future payment obligations as a result of such changes, and changes in rating agency policies and practices;

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

The tables below summarize the estimated effects of certain hypothetical increases and decreases in interest rates. It is assumed that the changes occur immediately and uniformly across each investment category. The hypothetical changes in market interest rates selected reflect the Company's expectations of the reasonably possible best or worst case scenarios over a one-year period. The hypothetical fair values are based upon the same prepayment assumptions that were utilized in computing fair values as of March 31, 2004. Significant variations in market interest rates could produce changes in the timing of repayments due to prepayment options available. The fair value of such instruments could be affected and therefore actual results might differ from those reflected in the following tables.

(DOLLARS IN THOUSANDS)	FAIR VALUE AT MARCH 31, 2004	HYPOTHETICAL CHANGE IN INTEREST RATE (BP=BASIS POINTS)	F HY IN

Fixed Income Securities:			
U.S. Government and government agencies and authorities....	\$ 85,433	200 bp increase	
		100 bp increase	
		100 bp decrease	
		200 bp decrease	

Edgar Filing: CNA SURETY CORP - Form 10-Q

States, municipalities and political subdivisions.....	412,479	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease
Corporate bonds and all other.....	147,917 -----	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease
Total fixed income securities.....	\$645,829 =====	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease

33

(DOLLARS IN THOUSANDS)	FAIR VALUE AT DECEMBER 31, 2003	HYPOTHETICAL CHANGE IN INTEREST RATE (BP=BASIS POINTS)	ES FAI HYPO CH INTE

Fixed Income Securities:			
U.S. Government and government agencies and authorities....	\$ 45,402	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease	\$
States, municipalities and political subdivisions.....	402,411	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease	
Corporate bonds and all other.....	132,243 -----	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease	
Total fixed income securities.....	\$ 580,056 =====	200 bp increase 100 bp increase 100 bp decrease 200 bp decrease	

ITEM 4. CONTROLS AND PROCEDURES

The Company maintains a system of disclosure controls and procedures which are designed to ensure that information required to be disclosed by the Company in reports that it files or submits to the Securities and Exchange Commission under the Securities and Exchange Act of 1934, including this report, is recorded, processed, summarized and reported on a timely basis. These disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed under the Exchange Act is accumulated and communicated to the Company's Management on a timely basis to allow decisions

Edgar Filing: CNA SURETY CORP - Form 10-Q

regarding required disclosure.

The Company's principal executive officer and its principal financial officer undertook an evaluation of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a - 15(e) and 15d - 15(e)) as of the end of the period covered by this report and concluded that the Company's controls and procedures were effective.

There were no changes in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

34

CNA SURETY CORPORATION AND SUBSIDIARIES

PART II - OTHER INFORMATION

- ITEM 1. LEGAL PROCEEDINGS - Information on the Company's legal proceedings is set forth in Notes 4 and 7 of the Condensed Consolidated Financial Statements included under Part 1, Item 1.
- ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS - None.
- ITEM 3. DEFAULTS UPON SENIOR SECURITIES - None.
- ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS - None.
- ITEM 5. OTHER INFORMATION - None
- ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K:

(a) Exhibits: -

31(1) Certification pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002-Chief Executive Officer.

31(2) Certification pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002--Chief Financial Officer.

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

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

(b) Reports on Form 8-K:

February 10, 2004; CNA Surety Corporation Press Release issued on February 10, 2004.

February 11, 2004; CNA Surety Corporation Press Release issued on February 11, 2004.

March 9, 2004; CNA Surety Corporation Press Release issued on March 8, 2004.

SIGNATURES

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

CNA SURETY CORPORATION
(Registrant)

/s/ John F. Welch

John F. Welch
President and Chief Executive Officer

/s/ John F. Corcoran

John F. Corcoran
Vice President and Chief Financial Officer

Date: May 10, 2004

EXHIBIT INDEX

- 31(1) Certification pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002--Chief Executive Officer.
- 31(2) Certification pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002--Chief Financial Officer.
- 32(1) Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002--Chief Executive Officer.
- 32(2) Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002--Chief Financial Officer.