CNA SURETY CORP
Form 10-Q
May 01, 2006

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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

For the quarterly period ended March 31, 2006

OR

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

For the transition period from ________________________to________________________

Commission file number: 1-13277

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

DELAWARE	36-4144905
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
CNA CENTER, CHICAGO, ILLINOIS	60685
(Address of principal executive offices)	(Zip Code)

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

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

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

Large accelerated filer [ ]   Accelerated filer [X]   Non-accelerated filer [ ]

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

43,575,029 shares of Common Stock, $.01 par value as of April 21, 2006.

CNA SURETY CORPORATION AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the accompanying condensed consolidated balance sheet of CNA Surety Corporation and subsidiaries as of March 31, 2006, and the related condensed consolidated statements of income, of stockholders' equity, and of

cash flows for the three-month periods ended March 31, 2006 and 2005. These interim financial statements are the responsibility of the Corporation's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of CNA Surety Corporation and subsidiaries as of December 31, 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated February 25, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2005 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Deloitte & Touche LLP
Chicago, Illinois
May 1, 2006

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

	MA
ASSETS	
Invested assets and cash:	
Fixed income securities, at fair value (amortized cost: $704,987 and $710,775)	$
Equity securities, at fair value (cost: $1,323 and $1,201)	
Short-term investments, at cost (approximates fair value)	
Other investments, at cost	
Total invested assets	
Cash	
Deferred policy acquisition costs	
Insurance receivables:	
Premiums, including $11,242 and $7,947 from affiliates, (net of allowance for doubtful accounts: $1,145 and $1,490)	

Reinsurance, including $56,149 and $53,025 from affiliates	
Deposit with affiliated ceding company	
Intangible assets (net of accumulated amortization: $25,523 and $25,523)	
Property and equipment, at cost (less accumulated depreciation and amortization: $21,200 and $24,887)	
Prepaid reinsurance premiums	
Accrued investment income	
Other assets	
Total assets	$ 1
LIABILITIES	
Reserves:	
Unpaid losses and loss adjustment expenses	$
Unearned premiums	
Total reserves	
Debt	
Deferred income taxes, net	
Current income taxes payable	
Reinsurance and other payables to affiliates	
Accrued expenses	
Other liabilities	
Total liabilities	$
Commitments and contingencies (See Notes 4, 5, 6, & 7)	
STOCKHOLDERS' EQUITY	
Common stock, par value $.01 per share, 100,000 shares authorized; 44,965 shares issued and 43,569 shares outstanding at March 31, 2006 and 44,734 shares issued and 43,334 shares outstanding at December 31, 2005	
Additional paid-in capital	
Retained earnings	
Accumulated other comprehensive income	
Treasury stock, at cost	
Total stockholders' equity	
Total liabilities and stockholders' equity	$ 1

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

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

	THREE MO MAR
	2006

Revenues:	
Net earned premium	$ 91,888
Net investment income	9,154
Net realized investment gains	18
Total revenues	101,060
Expenses:	
Net losses and loss adjustment expenses	23,596
Net commissions, brokerage and other underwriting expenses	50,913
Interest expense	952
Total expenses	75,461
Income before income taxes	25,599
Income tax expense	7,598
Net income	$ 18,001
Earnings per common share	$ 0.41
Earnings per common share, assuming dilution	$ 0.41
Weighted average shares outstanding	43,450
Weighted average shares outstanding, assuming dilution	43,692

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

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

	COMMON STOCK SHARES OUTSTANDING	COMMON STOCK
Balance, December 31, 2004	43,015	$ 44
Comprehensive income:		
Net income	--	-
Other comprehensive income:		
Change in unrealized gains on securities, after income taxes of $5,109, net of reclassification adjustment of ($103), after income tax benefit of $55	--	-
Total comprehensive income		
Stock options exercised and other	112	

Balance, March 31, 2005	43,127	$ 44
Balance, December 31, 2005.	43,334	$ 44
Comprehensive income:		
Net income	--	-
Other comprehensive income:		
Change in unrealized gains on securities, after income tax benefit of $3,293 (net of reclassification adjustment of $8, after income tax expense of $4)	--	-
Total comprehensive income		
Stock-based compensation	--	-
Stock options exercised and other	235	
Balance, March 31, 2006	43,569	$ 44

	RETAINED EARNINGS	ACCUMULA OTHER COMPREHEN INCOME
Balance, December 31, 2004	$ 185,496	$ 19,55
Comprehensive income:		
Net income	14,075	-
Other comprehensive income:		
Change in unrealized gains on securities, after income tax benefit of $5,109 (net of reclassification adjustment of ($103), after income tax benefit of $55)	--	(9,48
Stock options exercised and other		-
Balance, March 31, 2005	$ 199,571	$ 10,06
Balance, December 31, 2005	$ 223,927	$ 7,54
Comprehensive income:		
Net income	18,001	-
Other comprehensive income:		
Change in unrealized gains on securities, after income tax benefit of $3,293 (net of reclassification adjustment of $8, after income tax expense of $4)	--	(6,11
Stock-based compensation	--	-
Stock options exercised and other	--	-
Balance, March 31, 2006	$ 241,928	$ 1,43

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

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

	THREE MON MARC
	2006
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net income	$ 18,001
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	1,298
Accretion of bond discount, net	244
Loss on disposal of property and equipment	144
Net realized investment gains	(18)
Stock-based compensation	259
Changes in:	
Insurance receivables	(10,727)
Reserve for unearned premiums	10,230
Reserve for unpaid losses and loss adjustment expenses	1,733
Deposits with affiliated ceding company	491
Deferred policy acquisition costs	(2,850)
Deferred income taxes, net	300
Reinsurance and other payables to affiliates	(174)
Prepaid reinsurance premiums	(212)
Accrued expenses	(5,641)
Other assets and liabilities	1,127
Net cash provided by operating activities	14,205
CASH FLOWS FROM INVESTING ACTIVITIES:	
Fixed income securities:	
Purchases	(45,000)
Maturities	4,945
Sales	45,000
Purchases of equity securities	(292)
Proceeds from the sale of equity securities	194
Changes in short-term investments	(18,737)
Purchases of property and equipment, net	(2,055)
Changes in receivables/payables for securities sold/purchased	--
Other, net	(5)
Net cash (used in) provided by investing activities	(15,950)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Principal payments on debt	--
Employee stock option exercises and other	3,291
Net cash (used in) provided by financing activities	3,291
Increase in cash	1,546
Cash at beginning of period	8,323
Cash at end of period	$ 9,869

Supplemental Disclosure of Cash Flow Information:	
Cash paid during the period for:	
Interest	1,021
Income taxes	3,371

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

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CNA SURETY CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006
(UNAUDITED)

1. SIGNIFICANT ACCOUNTING POLICIES

FORMATION OF CNA SURETY CORPORATION 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"), Surety Bonding Company of America ("Surety Bonding") 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 63% of the outstanding common stock of CNA Surety. Loews Corporation ("Loews") owns approximately 91% of the outstanding common stock of CNAF. The principal operating subsidiaries of CNAF that wrote the surety line of business for their own account prior to the Merger were Continental Casualty Company and its property and casualty affiliates (collectively, "CCC") and The Continental Insurance Company and its property and casualty affiliates (collectively, "CIC"). CIC was acquired by CNAF on May 10, 1995.

PRINCIPLES OF CONSOLIDATION

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

ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

BASIS OF PRESENTATION

These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Company's 2005 Form 10-K. Certain financial information that is included in annual financial statements prepared in accordance with GAAP is not required for interim reporting and has been condensed or omitted. The accompanying unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all adjustments necessary for a fair presentation of

the interim financial statements. All such adjustments are of a normal and recurring nature. The financial results for interim periods may not be indicative of financial results for a full year. Certain reclassifications have been made to the 2005 financial statements to conform with the presentation in the 2006 Condensed Consolidated Financial Statements.

EARNINGS PER SHARE

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

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

Net income...

Shares:
  Weighted average shares outstanding...
  Weighted average shares of options exercised and additional stock issuance...................

Total weighted average shares outstanding..
  Effect of dilutive options..

Total weighted average shares outstanding, assuming dilution...................................

Earnings per share...

Earnings per share, assuming dilution...

No adjustments were made to reported net income in the computation of earnings per share. There were no options excluded from the calculation of diluted earnings per share for the three months ended March 31, 2006. Options to purchase shares of common stock of 0.5 million were excluded from the calculation of diluted earnings per share for the three months ended March 31, 2005 because the exercise price of these options was greater than the average market price of CNA Surety's common stock.

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

date. The following table illustrates the effect on net income and earnings per share data if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation under the Company's stock-based compensation plan (amounts in thousands, except for per share data):

Net income..
Less: Total stock-based compensation cost determined under the fair value method, net of tax.....
Pro forma net income..
Basic and diluted earnings per share, as reported...
Basic and diluted earnings per share, pro forma...

ACCOUNTING PRONOUNCEMENTS

In December of 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (revised 2004) ("SFAS No. 123R"), that amends SFAS No. 123, as originally issued in May of 1995. SFAS No. 123R addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. SFAS No. 123R supercedes APB 25. Under SFAS No. 123R, entities will not be permitted to use the intrinsic value method specified in APB 25 to measure compensation expense and generally would be required to measure compensation expense using a fair-value based method. Public companies are to apply SFAS No. 123R using either the modified prospective method or the modified retrospective method. The modified prospective method requires a company to (a) record compensation expense for all awards it grants after the date it adopts SFAS No. 123R and (b) record compensation expense for the unvested portion of previously granted awards that remain outstanding at the date of adoption. The modified retrospective method requires companies to record compensation expense to either (a) all prior years for which SFAS No. 123 was effective (i.e. for all fiscal years beginning after December 15, 2004) or (b) only to prior interim periods in the year of initial adoption if the effective date of SFAS No. 123R does not coincide with the beginning of the fiscal year. SFAS No. 123R was effective for the Company January 1, 2006. The Company applied the modified prospective transition method. The Company accounted for graded vesting using the accelerated method. Adoption of SFAS No. 123R decreased net income by $0.2 million for the quarter ended March 31, 2006.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Correction". This standard is a replacement of Accounting Policy Board Opinion No. 20 and FASB Standard No. 3. Under the new standard, any

voluntary changes in accounting principles should be adopted via a retrospective application of the accounting principle in the financial statements presented in

addition to obtaining an opinion from the auditors that the new principle is preferred. In addition, adoption of a change in accounting principle required by the issuance of a new accounting standard would also require retroactive restatement, unless the new standard includes explicit transition guidelines. This standard was effective for fiscal years beginning after December 15, 2005, and was adopted by the Company as of January 1, 2006. Adoption of this standard did not have a material impact on the Company's results of operations and/or equity.

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

2. INVESTMENTS

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

MARCH 31, 2006	AMORTIZED COST OR COST	GROSS UNREALIZED GAINS	GRO LESS MO
Fixed income securities:			
U.S. Treasury securities and obligations of U.S. Government and agencies:			
U.S. Treasury	$ 15,623	$ --	$
U.S. Agencies	40,047	10	
Collateralized mortgage obligations	18,163	303	
Mortgage pass-through securities	43,650	55	
Obligations of states and political subdivisions	462,045	10,397	
Corporate bonds	68,725	1,434	
Non-agency collateralized mortgage obligations	22,197	--	
Other asset-backed securities:			

Second mortgages/home equity loans	25,924	--	
Other	5,613	73	
Redeemable preferred stock	3,000	95	
Total fixed income securities	704,987	12,367	
Equity securities	1,323	141	
Total	$ 706,310	$ 12,508	$

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

The Company's investment portfolio generally is managed to maximize after-tax investment return, while minimizing credit risk, with investments concentrated in high quality fixed income securities. CNA Surety's portfolio is managed to provide diversification by limiting exposures to any one industry, issue or issuer, and to provide liquidity by investing in the public securities markets. The portfolio is structured to support CNA Surety's insurance underwriting operations and to consider the expected duration of liabilities and short-term cash needs. In achieving these goals, assets may be sold to take advantage of market conditions or other investment opportunities or regulatory, credit and tax considerations. These activities will produce realized gains and losses.

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

comprehensive income, exclusive of other-than-temporary impairment losses, if any.

As of March 31, 2006, 107 securities held by the Company were in an unrealized loss position. The Company believes that 106 of these securities are in an unrealized loss position because of changes in interest rates and therefore expects these securities will recover in value at or before maturity. Of these 106 securities, 80 were rated "AAA" by Standard & Poor's ("S&P") and "Aaa" by Moody's Investor Services ("Moody's"). Only fourteen of these 106 securities were in a loss position that exceeded 5% of its book value, with the largest unrealized loss, $0.5 million, being approximately 5.6% of that security's book value. The largest percentage unrealized loss was approximately 8.5% of that security's book value resulting in an unrealized loss of $0.1 million.

The remaining security that was in an unrealized loss position was issued by the financing subsidiary of a large domestic automaker. The security was in an unrealized loss position of approximately 9% ($0.3 million) of its book value and was rated below investment grade by S&P and Moody's. The Company believes that the financial condition and near-term prospects of the issuer are strong, and expects that the unrealized loss will reverse. The Company intends and believes it has the ability to hold this investment until the expected recovery in value, which may be at maturity.

Based on the foregoing information, the Company believes there are no other-than-temporary impairments at March 31, 2006.

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

3. REINSURANCE

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

	THREE MONTHS ENDED MAR		
	2006		
	WRITTEN	EARNED	WRI
Direct	$ 85,758	$ 75,221	$ 7
Assumed	26,971	27,277	2
Ceded	(10,823)	(10,610)	(1
Net premiums	$ 101,906	$ 91,888	$ 8

Assumed premiums primarily include all surety business written or renewed, net of reinsurance, by CCC and CIC, which is reinsured by Western Surety pursuant to reinsurance and related agreements.

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

	THREE MONTHS E	
	2006	
	$	RATIO
Gross losses and loss adjustment expenses	$ 26,854	26.2%
Ceded amounts	(3,258)	30.7%
Net losses and loss adjustment expenses	$ 23,596	25.7%

2006 THIRD PARTY REINSURANCE COMPARED TO 2005 THIRD PARTY REINSURANCE

Effective January 1, 2006, CNA Surety entered into a new excess of loss treaty ("2006 Excess of Loss Treaty") with a group of third party reinsurers on terms similar to the 2005 Excess of Loss Treaty. Under the 2006 Excess of Loss Treaty, the Company's net retention per principal remains at $10 million with a 5% co-participation in the $90 million layer of third party reinsurance coverage above the Company's retention. The material difference between the 2006 Excess of Loss Treaty and the Company's 2005 Excess of Loss Treaty is as follows. The base annual premium for the 2006 Excess of Loss Treaty is $36.9 million compared to the actual cost of the 2005 Excess of Loss Treaty of $41.5 million. The contract includes an optional extended discovery period, for an additional premium (a percentage of the original premium based on any unexhausted aggregate limit by layer), which will provide coverage for losses discovered beyond 2006 on bonds that were in force during 2006.

RELATED PARTY REINSURANCE

Reinsurance agreements together with the Services and Indemnity Agreement that are described below provide for the transfer of the surety business written by CCC and CIC to Western Surety.

The Services and Indemnity Agreement provides the Company's insurance subsidiaries the authority to perform various administrative, management, underwriting and claim functions in order to conduct the business of CCC and CIC and to be reimbursed by CCC for services rendered. In consideration for providing the foregoing services, CCC has agreed to pay Western Surety a quarterly fee of $50,000. This agreement was renewed on January 1, 2006 and expires on December 31, 2006 and is annually renewable thereafter.

Through a surety quota share treaty ("the Quota Share Treaty"), CCC and CIC transfer to Western Surety all surety business written or renewed by CCC and CIC after September 30, 1997 ("the Merger Date"). The Quota Share Treaty was renewed on January 1, 2006 and expires on December 31, 2006 and is annually renewable thereafter. CCC and CIC transfer the related liabilities of such business and

pay to Western Surety an amount in cash equal to CCC's and CIC's net written premiums written on all such business, minus a quarterly ceding commission to be retained by CCC and CIC equal to $50,000 plus 25% of net written premiums written on such business. This contemplates an approximate 4% override commission for fronting fees to CCC and CIC on their actual direct acquisition costs.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of 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, 2006.

Through a stop loss contract entered into at the Merger Date (the "Stop Loss Contract"), the Company's insurance subsidiaries were protected from adverse loss experience on certain business underwritten after the Merger Date. The Stop Loss Contract between the insurance subsidiaries and CCC limited the insurance subsidiaries' prospective net loss ratios with respect to certain accounts and lines of insured business for three full accident years following the Merger Date. In the event the insurance subsidiaries' accident year net loss ratio exceeded 24% in any of the accident years 1997 through 2000 on certain insured accounts (the "Loss Ratio Cap"), the Stop Loss Contract requires CCC at the end of each calendar quarter following the Merger Date, to pay the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which their actual accident year net loss ratio exceeds the applicable Loss Ratio Cap, multiplied by (ii) the applicable net earned premiums. As of March 31, 2006 and December 31, 2005, the Company had billed and received $45.9 million under the Stop Loss Contract.

The Company and CCC previously participated in a $40 million excess of $60 million reinsurance contract effective from January 1, 2005 to December 31, 2005 providing coverage exclusively for the one large national contractor excluded from the Company's third party reinsurance. The premium for this contract was $3.0 million plus an additional premium of $6.0 million if a loss is ceded under this contract. In the second quarter of 2005, this contract was amended to provide unlimited coverage in excess of the $60 million retention, to increase the premium to $7.0 million, and to eliminate the additional premium provision. This treaty provides coverage for the life of bonds either in force or written during the term of the treaty which was from January 1, 2005 to December 31, 2005. In November 2005, the Company and CCC agreed by addendum to extend this contract for twelve months. This extension, expiring December 31, 2006, was for an additional minimum premium of $0.8 million, subject to adjustment based on the level of actual premiums written on bonds for the large national contractor. As of March 31, 2006 and December 31, 2005, the Company has ceded losses of $50.0 million under the terms of this contract.

The Company and CCC entered into a $50 million excess of $100 million contract for the period of January 1, 2005 to December 31, 2005. The premium for this contract was $4.8 million plus an additional premium of $14.0 million if a loss was ceded under this contract. In the second quarter of 2005, this contract was amended to exclude coverage for the large national contractor, to reduce the premium to $3.0 million, and to reduce the additional premium to $7.0 million. As of December 31, 2005, no losses have been ceded under this contract, which was not renewed for 2006.

As of March 31, 2006 and December 31, 2005, CNA Surety had an insurance receivable balance from CCC and CIC of $67.4 million and $61.0 million, respectively. CNA Surety had no reinsurance payables to CCC and CIC as of March 31, 2006 and December 31, 2005.

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 MONT MARCH
	2006
Reserves at beginning of period:	
Gross	$ 424,449
Ceded reinsurance	147,435
Net reserves at beginning of period	277,014
Net incurred loss and loss adjustment expenses:	
Provision for insured events of current period	23,637
Decrease in provision for insured events of prior periods	(41)
Total net incurred	23,596
Net payments attributable to:	
Current period events	410
Prior period events	24,022
Total net payments	24,432
Net reserves at end of period	276,178
Ceded reinsurance at end of period	150,003
Gross reserves at end of period	$ 426,181

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5. DEBT

On July 27, 2005, the Company refinanced $30.0 million in outstanding borrowings under its previous credit facility with a new credit facility (the "2005 Credit Facility"). The 2005 Credit Facility provides an aggregate of up to $50.0 million in borrowings under a revolving credit facility. At March 31, 2006 and December 31, 2005, the outstanding 2005 Credit Facility balance was $20.0 million. The 2005 Credit Facility matures on June 30, 2008. No other debt matures in the next five years.

The term of borrowings under the 2005 Credit Facility may be fixed, at the Company's option, for a period of one, two, three, or six months. The interest rate is based on, among other rates, the London Interbank Offered Rate ("LIBOR")

plus the applicable margin. The margin, including a facility fee and utilization fee, can vary based on the Company's leverage ratio (debt to total capitalization) from 1.15% to 1.45%. The margin was 1.25% at March 31, 2006. As of March 31, 2006, the weighted average interest rate on the 2005 Credit Facility was 6.125% on the $20.0 million of outstanding borrowings.

The 2005 Credit Facility contains, among other conditions, limitations on the Company with respect to the incurrence of additional indebtedness and maintenance of a rating of at least A- by A.M. Best Company, Inc. ("A.M. Best") for each of the Company's insurance subsidiaries. The 2005 Credit Facility also requires the maintenance of certain financial ratios as follows: a) maximum funded debt to total capitalization ratio of 25%, b) minimum net worth of $375.0 million and c) minimum fixed charge coverage ratio of 2.5 times. The Company was in compliance with all covenants for the quarter ended March 31, 2006.

In May of 2004, the Company, through a wholly-owned trust, privately issued $30.0 million of preferred securities through two pooled transactions. These securities bear interest at a rate of LIBOR plus 337.5 basis points with a 30-year term and are redeemable after five years. The securities were issued by CNA Surety Capital Trust I (the "Issuer Trust"). The Company's investment of $0.9 million in the Issuer Trust is carried at cost in "Other assets" in the Company's Condensed Consolidated Balance Sheet. The sole asset of the Issuer Trust consists of a $30.9 million junior subordinated debenture issued by the Company to the Issuer Trust. The Company has also guaranteed the dividend payments and redemption of the preferred securities issued by the Issuer Trust. The maximum amount of undiscounted future payments the Company could make under the guarantee is $75.0 million, consisting of annual dividend payments of $1.5 million over 30 years and the redemption value of $30.0 million. Because payment under the guarantee would only be required if the Company does not fulfill its obligations under the debentures held by the Issuer Trust, the Company has not recorded any additional liabilities related to this guarantee.

The subordinated debenture bears interest at a rate of LIBOR plus 337.5 basis points and matures in April of 2034. As of March 31, 2006 the interest rate on the junior subordinated debenture was 8.12%.

6. EMPLOYEE BENEFITS

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

On April 25, 2005, the Board of Directors of CNA Surety Corporation approved the CNA Surety Corporation 2005 Deferred Compensation Plan (the "2005 Plan") and the CNA Surety Corporation 2005 Deferred Compensation Plan Trust (the "2005 Trust"). The 2005 Plan and 2005 Trust were adopted in connection with the enactment of Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"), which was implemented under the American Jobs Creation Act of 2004. The 2005 Plan and 2005 Trust will be used in lieu of the 2000 Plan and the CNA Surety Corporation Deferred Compensation Plan Trust (the "2000 Trust") for all amounts deferred on or after January 1, 2005. Amounts deferred under the 2000 Plan prior to January 1, 2005 will continue to be covered by and paid out in accordance with the terms of the 2000 Plan, the 2000 Trust and the elections made by participants under the 2000 Plan.

Western Surety sponsors two postretirement benefit plans covering certain employees. One plan provides medical benefits, and the other plan provides sick

leave termination payments. The postretirement health care plan is contributory and the sick leave plan is non-contributory. Western Surety uses a December 31 measurement date for both of its postretirement benefit plans. There were no plan assets for either of the postretirement benefit plans.

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

Net periodic benefit cost:
Service cost..
Interest cost...
Prior service cost..
Recognized net actuarial loss...

Net periodic benefit cost...

The Company expects to contribute $0.2 million to the postretirement benefit plans to pay benefits in 2006. As of March 31, 2006, $0.1 million of contributions have been made to the postretirement benefit plans.

7. COMMITMENTS AND CONTINGENCIES

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

8. STOCK-BASED COMPENSATION

The compensation expense recorded for the Company's stock-based compensation plan was $0.3 million in the current quarter. The total income tax benefit recognized in the income statement for stock-based compensation arrangements was $0.1 million in the current quarter. The amount of cash received from the exercise of stock options was $3.2 million and $1.3 million during the quarters ended March 31, 2006 and March 31, 2005, respectively.

1997 LONG-TERM EQUITY COMPENSATION PLAN

The Company has reserved shares of its common stock for issuance to directors, officers, employees and certain advisors of the Company through incentive stock options, non-qualified stock options and stock appreciation rights ("SARs") to be granted under the CNA Surety 1997 Long-Term Equity Compensation Plan ("the 1997 Plan"). The aggregate number of shares initially available for which options may be granted under the 1997 Plan is 3,000,000.

The Compensation Committee (the "Committee") of the Board of Directors, consisting of independent members of the Board of Directors, administers the 1997 Plan. The Committee determines the option exercise prices. Exercise prices may not be less than the fair market value of the Company's common stock on the

date of grant for incentive stock options and may not be less than the par value of the Company's common stock for non-qualified stock options.

The 1997 Plan provides for the granting of incentive stock options as defined under Section 382 of the Internal Revenue Code of 1986, as amended. All non-qualified stock options and incentive stock options granted under the 1997 Plan expire ten years after the date of grant and vest ratably over the four-year period following the date of grant.

No options were granted under the 1997 Plan during the quarters ended March 31, 2006 and March 31, 2005.

The Company's 2006 Long-Term Equity Compensation Plan ("the 2006 Plan"), which replaces the 1997 Plan, was approved by shareholders on April 25, 2006.

A summary of option activity as of March 31, 2006 is presented below:

	SHARES SUBJECT TO OPTION
Outstanding options at January 1, 2006	1,587,909
Options granted	--
Options forfeited/expired	(23,775)
Options exercised	(230,200)
Outstanding options at March 31, 2006	1,333,934

A summary of the status of the Company's non-vested options as of March 31, 2006 and changes during the quarter ended March 31, 2006 is presented below:

	SHARES SUBJECT TO OPTION
Non-vested options at January 1, 2006	785,845
Options granted	--
Options vested	--
Options forfeited	(4,100)
Non-vested options at March 31, 2006	781,745

As of March 31, 2006, the number of shares available for granting of options under the 1997 Plan was 566,077.

The following table summarizes information about stock options outstanding at March 31, 2006:

	OPTIONS OUTSTANDING			
RANGE OF EXERCISE PRICES	NUMBER OUTSTANDING	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED AVERAGE EXERCISE PRICE	N EXE
$9.35 to $11.50	397,750	6.6 years	$ 9.88	
$12.06 to $15.875	936,184	7.4 years	$ 13.36	

The aggregate intrinsic value of options outstanding and exercisable at March 31, 2006 were $5.9 million and $2.1 million, respectively. The total intrinsic value of options exercised during the quarter ended March 31, 2006 was $0.8 million.

As of March 31, 2006, there was $1.7 million of total unrecognized compensation cost related to non-vested stock-based compensation arrangements granted under the 1997 Plan. That cost is expected to be recognized as follows: 2006 - $0.9 million; 2007 - $0.5 million; 2008 - $0.2 million; and 2009 - $0.1 million.

CNA SURETY CORPORATION AND SUBSIDIARIES

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

GENERAL

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

CRITICAL ACCOUNTING POLICIES

Management believes the most significant accounting policies and related disclosures for purposes of understanding the Company's results of operations and financial condition pertain to reserves for unpaid losses and loss adjustment expenses and reinsurance, investments, intangible assets, recognition of premium revenue and the related unearned premium liability, and deferred policy acquisition costs. The Company's accounting policies related to reserves for unpaid losses and loss adjustment expenses and related estimates of reinsurance recoverables, are particularly critical to an assessment of the Company's financial results. These balances 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 ("LAE") under its surety and property and casualty insurance contracts based upon estimates of the ultimate amounts payable under the contracts related to losses occurring on or before the balance sheet date.

Reported claims are in various stages of the settlement process. Due to the nature of surety, which is the relationship among three parties whereby the surety guarantees the performance of the principal to a third party (the obligee), the investigation of claims and the establishment of case estimates on claim files can be a complex process that can occur over a period of time depending on the type of bond(s) and the facts and circumstances involving the particular bond(s), the claim(s) and the principal. Case reserves are typically established after a claim is filed and an investigation and analysis has been conducted as to the validity of the claim, the principal's response to the claim and the principal's financial viability. To the extent it is determined that there are no bona fide defenses to the claim and the principal is unwilling or financially unable to resolve the claim, a case estimate is established on the claim file for the amount the Company estimates it will have to pay to honor its obligations under the provisions of the bond(s).

While the Company intends to establish initial case reserve estimates that are sufficient to cover the ultimate anticipated loss on a file, some estimates need to be adjusted during the life cycle of the file as matters continue to develop. Factors that can necessitate case estimate increases or decreases are the complexity of the bond(s) and/or underlying contract(s), if additional and/or unexpected claims are filed, if the financial condition of the principal or obligee changes or as claims develop and more information is discovered that was unknown and/or unexpected at the time the initial case reserve estimate was established. Ultimately, claims are resolved through payment and/or a determination that, based on the information available, a case reserve is no longer required.

As of any balance sheet date, not all claims have been reported and some claims may not be reported for many years. As a result, the liability for unpaid losses includes significant estimates for incurred-but-not-reported ("IBNR") claims. The following table shows the estimated liability as of March 31, 2006 for unpaid claims applicable to reported claims and to IBNR (dollars in thousands) for each sub-line of business:

	GROSS CASE LOSS AND LAE RESERVES
Contract	$ 127,101
Commercial	105,889
Fidelity and other	4,391
Total	$ 237,381

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.

The Company's Condensed Consolidated Balance Sheets includes estimated liabilities for unpaid losses and loss adjustment expenses of $426.2 million and $424.4 million and reinsurance receivables related to unpaid losses of $150.0 million and $147.4 million at March 31, 2006 and December 31, 2005, respectively. Due to the inherent uncertainties in the process of establishing the liabilities for unpaid losses and loss adjustment expenses, the actual ultimate claims amounts will differ from the currently recorded amounts. This difference could have a material effect on reported earnings and financial condition. Future effects from changes in these estimates will be recorded in the period such changes are determined to be needed.

INVESTMENTS

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

The amortized cost of fixed income securities is determined based on cost and the cumulative effect of amortization of premiums and accretion of discounts 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 that approximates fair value. Invested assets are exposed to various risks, such as interest rate risk, market risk and credit risk. Due to the level of risk associated with invested assets and the level of uncertainty related to changes in the value of these assets, it is possible that changes in risks in the near term may significantly affect the amounts reported in the Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Income.

INTANGIBLE ASSETS

CNA Surety's Condensed Consolidated Balance Sheet as of March 31, 2006 and December 31, 2005 includes intangible assets of approximately $138.8 million. These amounts represent goodwill and identified intangibles arising from the acquisition of Capsure Holdings Corp. ("Capsure").

A significant amount of judgment is required in performing intangible assets impairment tests. Such tests are performed annually on October 1, or more frequently if events or changes indicate that the estimated fair value of CNA Surety's reporting units might be impaired. Under the relevant standard, fair value refers to the amount for which the entire reporting unit may be bought or sold. There are several methods of estimating fair value, including market quotations, asset and liability fair values and other valuation techniques, such as discounted cash flows and multiples of earnings or revenues. The Company uses a valuation technique based on discounted cash flows. If the carrying amount of a reporting unit, including goodwill, exceeds the estimated fair value, then individual assets, including identifiable intangible assets, and liabilities of the reporting unit are estimated at fair value. The excess of the estimated fair value of the reporting unit over the estimated fair value of net assets would establish the implied value of intangible assets. The excess of the recorded amount of intangible assets over the implied value of intangible assets is recorded as an impairment loss.

INSURANCE PREMIUMS

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

DEFERRED POLICY ACQUISITION COSTS

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

RESULTS OF OPERATIONS

FINANCIAL MEASURES

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

used in the calculation of net income and is a non-GAAP financial measure.

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

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

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

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

COMPARISON OF CNA SURETY RESULTS FOR THE THREE MONTHS ENDED MARCH 31, 2006 AND 2005

ANALYSIS OF NET INCOME

Net income for the three months ended March 31, 2006 was $18.0 million, compared to a net income of $14.1 million for the same period in 2005. This increase is primarily a result of higher net earned premium, higher net investment income, and the impacts of lower loss and expense ratios. 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, 2006 and 2005 are summarized in the following table (dollars in thousands):

Gross written premiums..

Net written premiums..

Net earned premiums...

Net losses and loss adjustment expenses...

Net commissions, brokerage and other expenses...

Loss ratio..
Expense ratio...

Combined ratio..

PREMIUMS WRITTEN

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

The Company assumes significant amounts of premiums primarily from affiliates. This includes all surety business written or renewed, net of reinsurance, by CCC and CIC, and their affiliates, after the Merger Date that is reinsured by Western Surety pursuant to reinsurance and related agreements. Because of certain regulatory restrictions that limit the Company's ability to write business on a direct basis, the Company continues to utilize the underwriting capacity available through these agreements. The Company is in full control of all aspects of the underwriting and claim management of the assumed business.

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

Contract..
Commercial..
Fidelity and other..

Total...

Gross written premiums increased 9.1% to $112.7 million, for the three months ended March 31, 2006 as compared with the same period in 2005. Contract surety gross written premiums increased 19.9% to $67.4 million due primarily to increased demand as a result of the strong construction economy as well as increased volume resulting from growth over the last several years in the number of targeted accounts serviced. Commercial surety gross written premiums decreased 3.6% to $35.9 million primarily due to declining premium volume on large commercial accounts. Fidelity and other premiums decreased by 3.9% primarily due to a decline in notary errors and omissions policies associated with a reduction in notary bond business of a large producer.

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

	THREE MONTHS ENDED MARCH 31, 2006	THREE MONTHS ENDED MARCH 31, 2005
Contract	$ 57,712	$ 40,052
Commercial	34,764	34,849
Fidelity and other	9,430	9,809
Total	$ 101,906	$ 84,710

Net written premiums increased 20.3% or $17.2 million, for the three months ended March 31, 2006 as compared with the same period in 2005, primarily due to the increase in gross written premiums as described above and a decrease in ceded written premiums. Ceded written premiums decreased $7.8 million for the three months ended March 31, 2006 as compared with the same period in 2005, resulting from the Company's decision not to renew a high-level excess of loss reinsurance treaty and cost savings on the Company's core reinsurance program.

EXCESS OF LOSS REINSURANCE

The Company's reinsurance program is predominantly comprised of excess of loss reinsurance contracts that limit the Company's retention on a per principal basis. The Company's reinsurance coverage is provided by third party reinsurers and related parties.

2006 THIRD PARTY REINSURANCE COMPARED TO 2005 THIRD PARTY REINSURANCE

Effective January 1, 2006, CNA Surety entered into a new excess of loss

treaty ("2006 Excess of Loss Treaty") with a group of third party reinsurers on terms similar to the 2005 Excess of Loss Treaty. Under the 2006 Excess of Loss Treaty, the Company's net retention per principal remains at $10 million with a 5% co-participation in the $90 million layer of third party reinsurance coverage above the Company's retention. The material difference between the 2006 Excess of Loss Treaty and the Company's 2005 Excess of Loss Treaty is as follows. The base annual premium for the 2006 Excess of Loss Treaty is $36.9 million compared to the actual cost of the 2005 Excess of Loss Treaty of $41.5 million. The contract includes an optional extended discovery period, for an additional premium (a percentage of the original premium based on any unexhausted aggregate limit by layer), which will provide coverage for losses discovered beyond 2006 on bonds that were in force during 2006.

RELATED PARTY REINSURANCE

Reinsurance agreements together with the Services and Indemnity Agreement that are described below provide for the transfer of the surety business written by CCC and CIC to Western Surety.

The Services and Indemnity Agreement provides the Company's insurance subsidiaries the authority to perform various administrative, management, underwriting and claim functions in order to conduct the business of CCC and CIC and to be reimbursed by CCC for services rendered. In consideration for providing the foregoing services, CCC has agreed to pay Western Surety a quarterly fee of $50,000. This agreement was renewed on January 1, 2006 and expires on December 31, 2006 and is annually renewable thereafter.

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

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of 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, 2006.

Through a stop loss contract entered into at the Merger Date (the "Stop Loss Contract"), the Company's insurance subsidiaries were protected from adverse loss experience on certain business underwritten after the Merger Date. The Stop Loss Contract between the insurance subsidiaries and CCC limited the insurance subsidiaries' prospective net loss ratios with respect to certain accounts and lines of insured business for three full accident years following the Merger Date. In the event the insurance subsidiaries' accident year net loss ratio exceeded 24% in any of the accident years 1997 through 2000 on certain insured accounts (the "Loss Ratio Cap"), the Stop Loss Contract requires CCC at the end of each calendar quarter following the Merger Date, to pay the insurance

subsidiaries a dollar amount equal to (i) the amount, if any, by which their actual accident year net loss ratio exceeds the applicable Loss Ratio Cap, multiplied by (ii) the applicable net earned premiums. As of March 31, 2006 and December 31, 2005, the Company had billed and received $45.9 million under the Stop Loss Contract.

The Company and CCC previously participated in a $40 million excess of $60 million reinsurance contract effective from January 1, 2005 to December 31, 2005 providing coverage exclusively for the one large national contractor excluded from the Company's third party reinsurance. The premium for this contract was $3.0 million plus an additional premium of $6.0 million if a loss is ceded under this contract. In the second quarter of 2005, this contract was amended to provide unlimited coverage in excess of the $60 million retention, to increase the premium to $7.0 million, and to eliminate the additional premium provision. This treaty provides coverage for the life of bonds either in force or written during the term of the treaty which was from January 1, 2005 to December 31, 2005. In November 2005, the Company and CCC agreed by addendum to extend this contract for twelve months. This extension, expiring December 31, 2006, was for an additional minimum premium of $0.8 million, subject to adjustment based on the level of actual premiums written on bonds for the large national contractor. As of March 31, 2006 and December 31, 2005, the Company has ceded losses of $50.0 million under the terms of this contract.

The Company and CCC entered into a $50 million excess of $100 million contract for the period of January 1, 2005 to December 31, 2005. The premium for this contract was $4.8 million plus an additional premium of $14.0 million if a loss was ceded under this contract. In the second quarter of 2005, this contract was amended to exclude coverage for the large national contractor, to reduce the premium to $3.0 million, and to reduce the additional premium to $7.0 million. As of December 31, 2005, no losses have been ceded under this contract, which was not renewed for 2006.

NET LOSS RATIO

The net loss ratio was 25.7% for the three months ended March 31, 2006 as compared with 26.8% for the same period in 2005. The lower loss ratio reflects improved claim experience and the increase in net earned premium that resulted from the Company's decision not to renew a high-level excess of loss reinsurance treaty and cost savings on the Company's core reinsurance program.

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 continues with various exposure management initiatives. These initiatives are particularly focused on exposure to large commercial accounts. Large commercial accounts are defined as accounts with exposures in excess of $10.0 million. "Exposure" is defined as the face amount of the bond. As the following table depicts, the Company has reduced its exposure, before the effects of reinsurance, to large commercial accounts with exposures in excess of $25.0 million. However, total large commercial account exposure has increased slightly in the first quarter of 2006.

	NUMBER OF ACCOUNTS AS OF		TOTAL EXPOSURE (DOLLARS I AS OF	
COMMERCIAL ACCOUNT EXPOSURE	MARCH 31, 2006	DECEMBER 31, 2005	MARCH 31, 2006	DECEMBER 31, 2005

$100 million and larger.............	2	2	$ 238.2	$ 246.6
$50 to $100 million.................	2	2	134.5	137.6
$25 to $50 million..................	8	9	266.3	307.7
$10 to $25 million..................	36	32	502.8	445.6
Total...............................	48	45	$1,141.8	$1,137.5

With respect to contract surety, the Company's portfolio is predominantly comprised of contractors with bonded backlog of less than $30.0 million. Bonded backlog is a measure of the Company's exposure in the event of default before indemnification, salvage and subrogation recoveries. The Company does have a number of accounts with higher bonded backlogs.

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

EXPENSE RATIO

The expense ratio was 55.4% for the three months ended March 31, 2006 as compared with 60.4% for the same period in 2005. Approximately 1.3 percentage points of this improvement resulted from the impact of the reduction in cost of the Company's 2006 reinsurance program. The remaining improvement reflects the strong premium growth accomplished with only a minimal increase in underwriting expenses.

INVESTMENT INCOME AND REALIZED INVESTMENT GAINS/LOSSES

Net investment income was $9.2 million for the three months ended March 31, 2006, as compared with $8.0 million for the same period in 2005. This is due to the significant increase in invested assets. The annualized pre-tax yield was 4.5% and 4.4% for the three months ended March 31, 2006 and 2005, respectively. The annualized after-tax yield was 3.8% and 3.7% for the three months ended March 31, 2006 and 2005, respectively. Net realized investment gains were negligible for the three months ended March 31, 2006 compared to $2.0 million for the three months ended March 31, 2005. This decrease was due to the absence of the realized investment gain in 2005 from the Company's sale of its interest in De Montfort Group, Ltd.

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

	THREE MONTHS ENDED MARCH 31,	
	2006	2005

Gross realized investment gains	$ 19	$ 2,165
Gross realized investment losses	(1)	(154)
Net realized investment gains	$ 18	$ 2,011

The Company's investment portfolio generally is managed to maximize after-tax investment return, while minimizing credit risk with investments concentrated in high quality fixed income securities. CNA Surety's portfolio is managed to provide diversification by limiting exposures to any one industry, issue or issuer, and to provide liquidity by investing in the public securities markets. The portfolio is structured to support CNA Surety's insurance underwriting operations and to consider the expected duration of liabilities and short-term cash needs. In achieving these goals, assets may be sold to take advantage of market conditions or other investment opportunities or regulatory, credit and tax considerations. These activities will produce realized gains and losses.

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

INTEREST EXPENSE

Interest expense increased by 23.0% for the three months ended March 31, 2006 as compared with the same period in 2005, due to higher interest rates associated with the Credit Facility and the subordinated debentures, partially offset by a reduction in weighted average debt outstanding. Weighted average debt outstanding was $50.9 million for the three months ended March 31, 2006 as compared with $65.9 million for the same period in 2005. The weighted average interest rate for the three months ended March 31, 2006 was 7.1% as compared with 4.5% for the same period in 2005.

INCOME TAXES

For the three months ended March 31, 2006, the Company's effective tax rate differs from the statutory tax rate due primarily to tax-exempt investment income. The impact of tax-exempt securities on taxable income was $4.3 million for the three months ended March 31, 2006. The impact of tax-exempt securities on taxable income was $3.9 million for the three months ended March 31, 2005.

LIQUIDITY AND CAPITAL RESOURCES

It is anticipated that the liquidity requirements of CNA Surety will be met primarily with funds generated from its insurance operations. The principal sources of consolidated cash flows are premiums, investment income, sales and maturities of investments, and reinsurance recoveries. CNA Surety also may generate funds from additional borrowings under the credit facility described below. The primary cash flow uses are payments for claims, operating expenses, reinsurance premiums, federal income taxes, and debt service. In general, surety operations generate premium collections from customers in advance of cash outlays for claims. Premiums are invested until such time as funds are required to pay claims and claims adjusting expenses.

The Company believes that total invested assets, including cash and

short-term investments, are sufficient in the aggregate and have suitably scheduled maturities to satisfy all policy claims and other operating liabilities, including dividend and income tax sharing payments of its insurance subsidiaries. At March 31, 2006, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of $706.2 million of fixed income securities, $71.8 million of short-term investments, $1.0 million of other investments and $10.7 million of cash. At December 31, 2005, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of $721.3 million of fixed income securities, $48.4 million of short-term investments, $1.0 million of other investments and $4.3 million of cash.

During the first quarter of 2006, the Company paid an additional $12.0 million related to the surety losses of the large national contractor discussed in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. The Company's exposure, net of expected reinsurance recoveries from CCC, of $60.0 million was previously fully reserved.

Cash flow at the parent company level is derived principally from dividend and tax sharing payments from its insurance subsidiaries. The principal obligations at the parent company level are to service debt and pay operating expenses, including income taxes. At March 31, 2006, the parent company's invested assets consisted of $0.8 million of fixed income securities, $1.5 million of equity securities, and $9.8 million of short-term investments and cash. At December 31, 2005, the parent company's invested assets consisted of $1.0 million of fixed income securities, $1.3 million of equity securities, and $19.2 million of short-term investments and cash. At March 31, 2006 and December 31, 2005 respectively, parent company short-term investments and cash included $1.5 million and $6.6 million of restricted cash primarily related to premium receipt collections ultimately due to the Company's insurance subsidiaries.

The Company's consolidated net cash flow provided by operating activities was $14.2 million for the three months ended March 31, 2006 compared to net cash flow provided by operating activities of $2.5 million for the comparable period in 2005. The increase in net cash flow provided by operating activities primarily relates to higher premiums received and lower loss payments.

On July 27, 2005, the Company refinanced $30.0 million in outstanding borrowings under its previous credit facility with a new credit facility (the "2005 Credit Facility"). The 2005 Credit Facility provides an aggregate of up to $50.0 million in borrowings under a revolving credit facility. At March 31, 2006 and December 31, 2005, the outstanding 2005 Credit Facility balance was $20.0 million. The 2005 Credit Facility matures on June 30, 2008. No other debt matures in the next five years.

The term of the borrowings under the 2005 Credit Facility may be fixed, at the Company's option, for a period of one, two, three, or six months. The interest rate is based on, among other rates, the London Interbank Offered Rate ("LIBOR") plus the applicable margin. The margin, including a facility fee and utilization fee, can vary based on the Company's leverage ratio (debt to total capitalization) from 1.15% to 1.45%. The margin was 1.25% at March 31, 2006. As of March 31, 2006, the weighted average interest rate on the 2005 Credit Facility was 6.125% on the $20.0 million of outstanding borrowings.

The 2005 Credit Facility contains, among other conditions, limitations on the Company with respect to the incurrence of additional indebtedness and maintenance of a rating of at least A- by A.M. Best Company, Inc. ("A.M. Best"). for each of the Company's insurance subsidiaries. The 2005 Credit Facility also requires the maintenance of certain financial ratios as follows: a) maximum funded debt to total capitalization ratio of 25%, b) minimum net worth of $375.0 million and c) minimum fixed charge coverage ratio of 2.5 times. The Company is in compliance with all covenants during the quarter ended March 31, 2006.

In May of 2004, the Company, through a wholly-owned trust, privately issued $30.0 million of preferred securities through two pooled transactions. These securities bear interest at a rate of LIBOR plus 337.5 basis points with a 30-year term and are redeemable after five years. The securities were issued by CNA Surety Capital Trust I (the "Issuer Trust"). The Company's investment of $0.9 million in the Issuer Trust is carried at cost in "Other assets" in the Company's Condensed Consolidated Balance Sheet. The sole asset of the Issuer Trust consists of a $30.9 million junior subordinated debenture issued by the Company to the Issuer Trust. The

Company has also guaranteed the dividend payments and redemption of the preferred securities issued by the Issuer Trust. The maximum amount of undiscounted future payments the Company could make under the guarantee is $75.0 million, consisting of annual dividend payments of $1.5 million over 30 years and the redemption value of $30.0 million. Because payment under the guarantee would only be required if the Company does not fulfill its obligations under the debentures held by the Issuer Trust, the Company has not recorded any additional liabilities related to this guarantee.

The subordinated debenture bears interest at a rate of LIBOR plus 337.5 basis points and matures in April of 2034. As of March 31, 2006 the interest rate on the junior subordinated debenture was 8.12%.

A summary of the Company's commitments as of March 31, 2006 is presented in the following table (in millions):

MARCH 31, 2006	2006	2007	2008	2009	2
Debt (a)	$ 3.1	$ 3.7	$ 23.3	$ 2.5	$
Operating leases	1.4	1.8	1.6	1.7	
Loss and loss adjustment expense reserves	152.0	172.1	45.7	12.2	
Other long-term liabilities (b)	0.3	0.8	0.7	0.5	
Total	$ 156.8	$ 178.4	$ 71.3	$ 16.9	$

(a) Reflects expected principal and interest payments.

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

As an insurance holding company, CNA Surety is dependent upon dividends and other permitted payments from its insurance subsidiaries to pay operating expenses, meet debt service requirements, as well as to pay cash dividends. The payment of dividends by the insurance subsidiaries is subject to varying degrees of supervision by the insurance regulatory authorities in South Dakota and Texas. In South Dakota, where Western Surety and Surety Bonding 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 2006 is based on statutory surplus and income at and for the year ended December 31, 2005. Without prior regulatory approval, CNA Surety's insurance subsidiaries may pay stockholder dividends of $39.1 million in the aggregate in 2006. CNA Surety received no dividends from its insurance subsidiaries during the first three months of 2006 or 2005. CNA Surety received no dividends from its non-insurance subsidiaries during the first three months of 2006. CNA Surety received $1.5 million in dividends, including $0.5 million in cash, from its non-insurance subsidiaries during the first three months of 2005.

Combined statutory surplus totaled $292.1 million at March 31, 2006, resulting in a net written premium to statutory surplus ratio of 1.3 to 1. Insurance regulations restrict Western Surety's maximum net retention on a single surety bond to 10 percent of statutory surplus. Under the 2006 Excess of Loss Treaty, the Company's net retention on new bonds would generally be $10 million plus a 5% co-participation in the $90 million layer of excess reinsurance above the Company's retention and this regulation would require minimum statutory surplus of $145.0 million at Western Surety. At March 31, 2006, Western Surety's statutory surplus was $292.1 million. This surplus requirement may limit the amount of future dividends Western Surety could otherwise pay to CNA Surety.

In accordance with the provisions of inter-company tax sharing agreements between CNA Surety and its subsidiaries, the tax of each subsidiary shall be determined based upon each subsidiary's separate return liability. Intercompany tax payments are made at such times when estimated tax payments would be required by (or refunds received from) the Internal Revenue Service ("IRS"). CNA Surety received $3.1 million and $0.7 million from its subsidiaries for the three months ended March 31, 2006 and March 31, 2005, respectively.

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Western Surety and Surety Bonding each qualify as an acceptable surety for federal and other public works project bonds pursuant to U.S. Department of Treasury regulations. U.S. Treasury underwriting limitations are based on an insurer's statutory surplus. Effective July 1, 2005 through June 30, 2006, the underwriting limitations of Western Surety and Surety Bonding are $24.6 million and $0.7 million, respectively. Through the Surety Quota Share Treaty between CCC and Western Surety Company, CNA Surety has access to CCC and its affiliates' U.S. Department of Treasury underwriting limitations. The Surety Quota Share Treaty had an original term of five years from the Merger Date and was renewed on October 1, 2002, January 1, 2004, January 1, 2005, and January 1, 2006 on substantially the same terms. Effective July 1, 2005 through June 30, 2006, the underwriting limitations of CCC and its affiliates total $645.7 million. CNA Surety management believes that the foregoing U.S. Treasury underwriting

limitations are sufficient for the conduct of its business.

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

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FINANCIAL CONDITION

INVESTMENT PORTFOLIO

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

MARCH 31, 2006	AMORTIZED COST OR COST	GROSS UNREALIZED GAINS
Fixed income securities:		
U.S. Treasury securities and obligations of U.S. Government and agencies:		
U.S. Treasury	$ 15,623	$ --
U.S. Agencies	40,047	10
Collateralized mortgage obligations	18,163	303
Mortgage pass-through securities	43,650	55
Obligations of states and political subdivisions	462,045	10,397
Corporate bonds	68,725	1,434
Non-agency collateralized mortgage obligations	22,197	--
Other asset-backed securities:		
Second mortgages/home equity loans	25,924	--
Other	5,613	73
Redeemable preferred stock	3,000	95
Total fixed income securities	704,987	12,367
Equity securities	1,323	141
Total	$ 706,310	$ 12,508

DECEMBER 31, 2005	AMORTIZED COST OR COST	GROSS UNREALIZED GAINS

Fixed income securities:			
U.S. Treasury securities and obligations of U.S. Government and agencies:			
U.S. Treasury	$ 15,637	$ --	$
U.S. Agencies	40,055	131	
Collateralized mortgage obligations	18,696	432	
Mortgage pass-through securities	45,607	87	
Obligations of states and political subdivisions	464,417	14,424	
Corporate bonds	69,626	1,885	
Non-agency collateralized mortgage obligations	22,200	--	
Other asset-backed securities:			
Second mortgages/home equity loans	25,924	21	
Credit card receivables			
Other	5,613	93	
Redeemable preferred stock	3,000	128	
Total fixed income securities	710,775	17,201	
Equity securities	1,201	105	
Total	$ 711,976	$ 17,306	$

The following table summarizes for fixed income securities in an unrealized loss position at March 31, 2006 and 2005, the aggregate fair value and gross unrealized loss by length of time those securities have been continuously in an unrealized loss position (dollars in thousands):

UNREALIZED LOSS AGING	MARCH 31, 2006 ESTIMATED FAIR VALUE	GROSS UNREALIZED LOSS	ESTIM FAIR
Fixed income securities:			
0-6 months	$ 124,923	$ 1,403	$ 2
7-12 months	176,786	6,429	
13-24 months	37,416	1,380	
Greater than 24 months	18,538	1,094	
Total	$ 357,663	$ 10,306	$ 2

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

climate or credit ratings.

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

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

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

As of March 31, 2006, 107 securities held by the Company were in an unrealized loss position. The Company believes that 106 of these securities are in an unrealized loss position because of changes in interest rates and therefore expects these securities will recover in value at or before maturity. Of these 106 securities, 80 were rated "AAA" by Standard & Poor's ("S&P") and "Aaa" by Moody's Investor Services ("Moody's"). Only fourteen of these 106 securities were in a loss position that exceeded 5% of its book value, with the largest unrealized loss, $0.5 million, being approximately 5.6% of that security's book value. The largest percentage unrealized loss was approximately 8.5% of that security's book value resulting in an unrealized loss of $0.1 million.

The remaining security that was in an unrealized loss position was issued by the financing subsidiary of a large domestic automaker. The security was in an unrealized loss position of approximately 9% of its book value and was rated below investment grade by S&P and Moody's. The Company believes that the financial condition and near-term prospects of the issuer are strong, and expects that the unrealized loss will reverse. The Company intends and believes it has the ability to hold this investment until the expected recovery in value, which may be at maturity.

Based on the foregoing information, the Company believes there are no other-than-temporary impairments at March 31, 2006.

IMPACT OF PENDING ACCOUNTING STANDARDS

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

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

FORWARD-LOOKING STATEMENTS

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

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

- general economic and business conditions;

- changes in financial markets such as fluctuations in interest rates, long-term periods of low interest rates, credit conditions and currency, commodity and stock prices;

- the ability of the Company's contract principals to fulfill their bonded obligations;

- the effects of corporate bankruptcies on surety bond claims, as well as on capital markets;

- changes in foreign or domestic political, social and economic conditions;

- regulatory initiatives and compliance with governmental regulations, judicial decisions, including interpretation of policy provisions, decisions regarding coverage, trends in litigation and the outcome of any litigation involving the Company, and rulings and changes in tax laws and regulations;

- regulatory limitations, impositions and restrictions upon the Company, including the effects of assessments and other surcharges for guaranty

funds and other mandatory pooling arrangements;

- the impact of competitive products, policies and pricing and the competitive environment in which the Company operates, including changes in the Company's books of business;

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

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

- the performance of reinsurance companies under reinsurance contracts with the Company;

- results of financing efforts, including the availability of bank credit facilities;

- changes in the Company's composition of operating segments;

- the sufficiency of the Company's loss reserves and the possibility of future increases in reserves;

- the risks and uncertainties associated with the Company's loss reserves; and,

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

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

CNA Surety's investment portfolio is subject to economic losses due to adverse changes in the fair value of its financial instruments, or market risk. Interest rate risk represents the largest market risk factor affecting the 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, 2006. Significant variations in market interest rates could produce changes in the timing of repayments due to prepayment options available. The fair value of such instruments could be affected and therefore actual results might differ from those reflected in the following tables.

	FAIR VALUE AT MARCH 31, 2006	HYPOTHETICAL CHANGE IN INTEREST RATE (BP=BASIS POINTS)
		(DOLLARS I
U.S. Government and government agencies and authorities......	$ 114,735	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
States, municipalities and political subdivisions...........	468,891	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
Corporate bonds and all other..............................	123,422	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
Total fixed income securities available-for-sale............	$ 707,048	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease

	FAIR VALUE AT DECEMBER 31, 2005	HYPOTHETICAL CHANGE IN INTEREST RATE (BP=BASIS POINTS
		(DOLLARS

U.S. Government and government agencies and authorities......	$ 118,856	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
States, municipalities and political subdivisions...........	477,084	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
Corporate bonds and all other...............................	126,339	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease
Total fixed income securities available-for-sale............	$ 722,279	200 bp increase
		100 bp increase
		100 bp decrease
		200 bp decrease

ITEM 4. CONTROLS AND PROCEDURES

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

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

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

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS - Information on the Company's legal proceedings is set forth in Note 7 of the Condensed Consolidated Financial Statements included under Part 1, Item 1.

ITEM 1A. RISK FACTORS - Information on the Company's risk factors is set forth in Item 1A "Risk Factors" in the Company's Annual Report on Form 10-K for the year-ended December 31, 2005.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS - None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES - None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS -

At the Annual Meeting of Shareholders of CNA Surety Corporation held on April 25, 2006, the Company's shareholders voted on the following proposals. The numbers of shares issued, outstanding and eligible to vote as of the record date of March 1, 2006 were 43,489,474. Proxies representing 42,648,125 shares or approximately 98 percent of the eligible voting shares were tabulated.

PROPOSAL I

Election of Directors.

	NUMBER OF SHARES/VOTES	
	FOR	AUTHORITY WITHHELD
Philip H. Britt............................	42,098,310	549,815
Roy E. Posner..............................	41,899,710	748,415
Adrian M. Tocklin..........................	41,898,678	749,447
James R. Lewis.............................	39,242,914	3,405,211
Lori Komstadius............................	39,241,298	3,406,827
Robert Tinstman............................	42,099,027	549,098
John F. Welch..............................	39,242,514	3,405,611

PROPOSAL II

To approve the Company's proposed 2006 Long-Term Equity Compensation Plan.

For...	34,220,932
Against...	7,111,281
Abstain...	1,315,912

PROPOSAL III

To ratify the Board of Directors' appointment of the Company's independent registered public accounting firm, Deloitte & Touche LLP, for fiscal year 2006.

For...	42,284,857
Against...	92,276
Abstain...	270,992

ITEM 5. OTHER INFORMATION - Reports on Form 8-K:

February 16, 2006; CNA Surety Corporation Earnings Press Release issued on February 16, 2006

February 16, 2006; CNA Surety Corporation adoption of a new 2006 Long-Term Equity Compensation Plan

ITEM 6. EXHIBITS

Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Secti
Sarbanes-Oxley Act of 2002..

Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Secti
Sarbanes-Oxley Act of 2002..

Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Secti
Sarbanes-Oxley Act of 2002..

Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Secti
Sarbanes-Oxley Act of 2002..

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

SIGNATURES

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

CNA SURETY CORPORATION (Registrant)

/s/ John F. Welch

John F. Welch
President and Chief Executive Officer

/s/ John F. Corcoran

John F. Corcoran
Senior Vice President and Chief Financial Officer

Date: May 1, 2006

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.