CNA SURETY CORP
Form 10-Q
July 27, 2007

Table of Contents

FORM 10-Q
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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

For the quarterly period ended June 30, 2007

OR

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

For the transition period from __________ to __________

Commission file number: 1-13277

CNA SURETY CORPORATION

(Exact name of Registrant as specified in its Charter)

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 o Accelerated filer þ Non-accelerated filer o

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

43,995,284 shares of Common Stock, $.01 par value as of July 20, 2007.

CNA SURETY CORPORATION AND SUBSIDIARIES
INDEX

	Page
PART I. FINANCIAL INFORMATION	
Item 1. Condensed Consolidated Financial Statements (Unaudited):	3
Condensed Consolidated Balance Sheets at June 30, 2007 and at December 31, 2006	3
Condensed Consolidated Statements of Income for the Three and Six Months Ended June 30, 2007 and 2006	4
Condensed Consolidated Statements of Stockholders Equity for the Six Months Ended June 30, 2007 and 2006	5
Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2007 and 2006	6
Notes to Condensed Consolidated Financial Statements	7
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	15
Item 3. Quantitative and Qualitative Disclosures About Market Risk	31
Item 4. Controls and Procedures	33
PART II. OTHER INFORMATION	33
Item 1. Legal Proceedings	33
Item 1A. Risk Factors	33
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	33
Item 3. Defaults Upon Senior Securities	33
Item 4. Submission of Matters to a Vote of Security Holders	33
Item 5. Other Information	33
Item 6. Exhibits	33

302 Certification of Chief Executive Officer
302 Certification of Chief Financial Officer
906 Certification of Chief Executive Officer
906 Certification of Chief Financial Officer

Table of Contents

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

	June 30, 2007	December 31, 2006
ASSETS		
Invested assets:		
Fixed income securities, at fair value (amortized cost: $855,090 and $773,178)	$ 851,049	$ 784,791
Equity securities, at fair value (cost: $1,664 and $1,508)	1,900	1,668
Short-term investments, at cost (approximates fair value)	54,276	103,640
Other investments, at cost	60	22
Total invested assets	907,285	890,121
Cash	5,331	7,164
Deferred policy acquisition costs	109,012	102,937
Insurance receivables:		
Premiums, including $16,244 and $6,885 from affiliates, (net of allowance for doubtful accounts: $1,185 and $1,369)	53,491	37,205
Reinsurance, including $49,800 and $55,023 from affiliates	114,371	118,412
Deposit with affiliated ceding company	33,866	33,145
Intangible assets (net of accumulated amortization: $25,523 and $25,523)	138,785	138,785
Current income taxes receivable	239	323
Property and equipment, at cost (less accumulated depreciation and amortization: $27,014 and $24,466)	24,918	24,807
Prepaid reinsurance premiums (including $715 and $1,702 from affiliates)	1,027	2,165
Accrued investment income	11,334	10,089
Other assets	1,689	3,180
Total assets	$ 1,401,348	$ 1,368,333
LIABILITIES		
Reserves:		
Unpaid losses and loss adjustment expenses	$ 435,569	$ 434,224
Unearned premiums	273,664	253,803
Total reserves	709,233	688,027
Debt	30,740	30,690
Deferred income taxes, net	11,462	17,298
Reinsurance and other payables to affiliates	285	166
Accrued expenses	13,597	20,247
Liability for postretirement benefits	12,781	12,466
Other liabilities	22,023	33,537
Total liabilities	800,121	802,431
Commitments and contingencies (See Notes 3, 4, & 7)		
STOCKHOLDERS EQUITY		

Common stock, par value $.01 per share, 100,000 shares authorized; 45,379 shares issued and 43,991 shares outstanding at June 30, 2007 and 45,263 shares issued and 43,872 shares outstanding at December 31, 2006	454	453
Additional paid-in capital	271,368	268,651
Retained earnings	349,388	306,745
Accumulated other comprehensive income	(5,080)	4,993
Treasury stock, 1,388 and 1,391 shares, at cost	(14,903)	(14,940)
Total stockholders equity	601,227	565,902
Total liabilities and stockholders equity	$ 1,401,348	$ 1,368,333

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

3

Table of Contents

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Revenues:				
Net earned premium	$ 105,687	$ 97,041	$ 203,990	$ 188,929
Net investment income	10,763	10,017	21,464	19,171
Net realized investment gains (losses)	(830)	87	(551)	105
Total revenues	115,620	107,145	224,903	208,205
Expenses:				
Net losses and loss adjustment expenses	26,854	24,945	51,797	48,541
Net commissions, brokerage and other underwriting expenses	57,020	53,514	110,918	104,427
Interest expense	728	1,012	1,449	1,964
Total expenses	84,602	79,471	164,164	154,932
Income before income taxes	31,018	27,674	60,739	53,273
Income tax expense	9,124	8,185	18,096	15,783
Net income	$ 21,894	$ 19,489	$ 42,643	$ 37,490
Earnings per common share	$ 0.50	$ 0.45	$ 0.97	$ 0.86
Earnings per common share, assuming dilution	$ 0.50	$ 0.45	$ 0.96	$ 0.86
Weighted average shares outstanding	43,938	43,519	43,959	43,545
Weighted average shares outstanding, assuming dilution	44,217	43,765	44,248	43,788

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

Table of Contents

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

	Common Stock Shares Outstanding	Common Stock	Additional Paid-In Capital	Comprehensive Income (Loss)	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock At Cost	Total Stockholders Equity
Balance, December 31, 2005	43,334	$ 447	$ 259,684		$ 223,927	$ 7,546	$ (15,029)	$ 476,575
Comprehensive income:								
Net income				$ 37,490	37,490			37,490
Other comprehensive income:								
Change in unrealized gains on securities, after income tax benefit of $6,235 (net of reclassification adjustment of $107, after income tax expense of $58)				(11,580)		(11,580)		(11,580)
Total comprehensive income				$ 25,910				
Stock-based compensation			646					646
Stock options exercised and other	342	4	4,864				44	4,912
Balance, June 30, 2006	43,676	$ 451	$ 265,194		$ 261,417	$ (4,034)	$ (14,985)	$ 508,043
Balance, December 31, 2006	43,872	$ 453	$ 268,651		$ 306,745	$ 4,993	$ (14,940)	$ 565,902
Comprehensive income:								
Net income				$ 42,643	42,643			42,643
Other comprehensive income:								
Change in unrealized gains on securities, after income tax benefit of $5,452 (net of reclassification adjustment of ($142), after income tax benefit of $76)				(10,126)		(10,126)		(10,126)
Adjustment to postretirement benefit plan net periodic cost, after income tax expense of $29				53		53		53
Total comprehensive income				$ 32,570				

Stock-based compensation			980				980
Stock options exercised and other	119	1	1,737			37	1,775
Balance, June 30, 2007	43,991	$ 454	$ 271,368	$ 349,388	$ (5,080)	$ (14,903)	$ 601,227

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

Table of Contents

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

	Six Months Ended June 30,	
	2007	**2006**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 42,643	$ 37,490
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for doubtful accounts	151	351
Depreciation and amortization	3,207	2,557
Amortization (accretion) of bond premium (discount), net	98	(74)
Loss on disposal of property and equipment	8	148
Net realized investment (gains) losses	551	(105)
Stock-based compensation	980	646
Changes in:		
Insurance receivables	(12,396)	(25,292)
Reserve for unearned premiums	19,861	21,016
Reserve for unpaid losses and loss adjustment expenses	1,345	11,276
Deposits with affiliated ceding company	(721)	610
Deferred policy acquisition costs	(6,075)	(4,161)
Deferred income taxes, net	(486)	(320)
Reinsurance and other payables to affiliates	119	(6)
Prepaid reinsurance premiums	1,138	1,159
Accrued expenses	(6,650)	(2,759)
Other assets and liabilities	(10,715)	(4,901)
Net cash provided by operating activities	33,058	37,635
CASH FLOWS FROM INVESTING ACTIVITIES:		
Fixed income securities:		
Purchases	(101,829)	(164,475)
Maturities	12,428	14,067
Sales	5,359	91,577
Purchases of equity securities	(320)	(502)
Proceeds from the sale of equity securities	202	373
Changes in short-term investments	50,790	20,832
Purchases of property and equipment, net	(3,275)	(5,566)
Other, net	(21)	(13)
Net cash used in investing activities	(36,666)	(43,707)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Employee stock option exercises and other	1,775	4,911
Net cash provided by financing activities	1,775	4,911

Decrease in cash		(1,833)		(1,161)
Cash at beginning of period		7,164		8,323
Cash at end of period	$	5,331	$	7,162
Supplemental Disclosure of Cash Flow Information:				
Cash paid during the period for:				
Interest	$	1,399	$	1,984
Income taxes		18,128		18,094

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

CNA SURETY CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2007
(UNAUDITED)

1. SIGNIFICANT ACCOUNTING POLICIES

FORMATION OF CNA SURETY CORPORATION AND MERGER

In December 1996, CNA Financial Corporation (CNAF) and Capsure Holdings Corp. (Capsure) agreed to merge (the Merger) the surety business of CNAF with Capsure s insurance subsidiaries, Western Surety Company (Western Surety), Surety Bonding Company of America (Surety Bonding) and Universal Surety of America (Universal Surety), into CNA Surety Corporation (CNA Surety or the Company). CNAF, through its operating subsidiaries, writes multiple lines of property and casualty insurance, including surety business that is reinsured by Western Surety. CNAF owns approximately 62% of the outstanding common stock of CNA Surety. Loews Corporation (Loews) owns approximately 89% of the outstanding common stock of CNAF. The principal operating subsidiaries of CNAF that wrote the surety line of business for their own account prior to the Merger were Continental Casualty Company and its property and casualty affiliates (collectively, CCC) and The Continental Insurance Company and its property and casualty affiliates (collectively, CIC).

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 2006 Form 10-K. Certain financial information that is included in annual financial statements prepared in accordance with GAAP is not required for interim reporting and has been condensed or omitted. The accompanying unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all adjustments necessary for a fair presentation of the interim financial statements. All such adjustments are of a normal and recurring nature. The financial results for interim periods may not be indicative of financial results for a full year.

EARNINGS PER SHARE

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

Table of Contents

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net income	$ 21,894	$ 19,489	$ 42,643	$ 37,490
Shares:				
Weighted average shares outstanding	43,931	43,450	43,872	43,334
Weighted average shares of options exercised and additional stock issuance	7	69	87	211
Total weighted average shares outstanding	43,938	43,519	43,959	43,545
Effect of dilutive options	279	246	289	243
Total weighted average shares outstanding, assuming dilution	44,217	43,765	44,248	43,788
Earnings per share	$ 0.50	$ 0.45	$ 0.97	$ 0.86
Earnings per share, assuming dilution	$ 0.50	$ 0.45	$ 0.96	$ 0.86

No adjustments were made to reported net income in the computation of earnings per share. Options to purchase shares of common stock of 0.3 million were excluded from the calculation of diluted earnings per share for the three months ended June 30, 2007 because the exercise price of these options was greater than the average market price of CNA Surety s common stock. There were no options excluded from the calculation of diluted earnings per share for the six months ended June 30, 2007. There were no options excluded from the calculation of diluted earnings per share for the three and six months ended June 30, 2006.

ACCOUNTING PRONOUNCEMENTS

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. FIN 48 states that a tax benefit from an uncertain position may be recognized only if it is more likely than not that the position is sustainable, based on its technical merits. The tax benefit of a qualifying position is the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority having full knowledge of all relevant information. FIN 48 is effective for fiscal years beginning after December 15, 2006 and was adopted by the Company as of January 1, 2007. The Company has elected to classify interest, if any, recognized in accordance with FIN 48 as interest expense. Likewise, penalties, if any, recognized in accordance with FIN 48 will be classified as miscellaneous expense. No amounts have been recognized subject to these provisions as of June 30, 2007. As of June 30, 2007, the tax years 2003 and beyond remain subject to examination by the Internal Revenue Service. Adoption and subsequent application of this standard did not have an impact on the Company s results of operations and financial condition.

In February 2006, the FASB issued Statement of Accounting Financial Standards (SFAS) No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS 155). SFAS 155 amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS 140). 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 eliminates the exemption from applying SFAS 133 to interests in certain securitized financial assets so that similar instruments are accounted for in the same manner regardless of the form of the instruments. SFAS 155 also allows 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. 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. 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, and was adopted by the Company as of January 1, 2007. Adoption and subsequent application of this standard did not have an impact on the Company s results of operations and financial condition.

In September 2005, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants issued Statement of Position (SOP) 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts (SOP 05-1). SOP 05-1 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in SFAS No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments . SOP 05-1 defines an internal replacement as a modification in product benefits,

Table of Contents

features, rights, or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or rider to a contract, or by the election of a feature or coverage within a contract. SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006 and was adopted by the Company as of January 1, 2007. Adoption and subsequent application of this standard did not have an impact on the Company s results of operations and financial condition.

2. INVESTMENTS

The estimated fair value and amortized cost or cost of fixed income and equity securities held by CNA Surety at June 30, 2007 and December 31, 2006, by investment category, were as follows (dollars in thousands):

June 30, 2007	**Amortized Cost or Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses Less Than 12 Months**	**Gross Unrealized Losses More Than 12 Months**	**Estimated Fair Value**
Fixed income securities:					
U.S. Treasury securities and obligations of U.S. Government and agencies:					
U.S. Treasury	$ 14,803	$	$	$ (392)	$ 14,411
U.S. Agencies	76,837	35	(170)	(182)	76,520
Collateralized mortgage obligations	21,192	232	(150)	(449)	20,825
Mortgage pass-through securities	35,787	45		(1,604)	34,228
Obligations of states and political subdivisions	566,317	6,296	(5,237)	(47)	567,329
Corporate bonds	56,634	759		(1,626)	55,767
Non-agency collateralized mortgage obligations	37,000	7	(20)	(1,301)	35,686
Other asset-backed securities:					
Second mortgages/home equity loans	18,483			(101)	18,382
Credit card receivables	17,232	15	(1)		17,246
Other	10,805	63		(213)	10,655
Total fixed income securities	855,090	7,452	(5,578)	(5,915)	851,049
Equity securities	1,664	236			1,900
Total	$ 856,754	$ 7,688	$ (5,578)	$ (5,915)	$ 852,949

December 31, 2006	**Amortized Cost or Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses Less Than 12 Months**	**Gross Unrealized Losses More Than 12 Months**	**Estimated Fair Value**
Fixed income securities:					
U.S. Treasury securities and obligations of U.S. Government and agencies:					
U.S. Treasury	$ 14,832	$	$	$ (327)	$ 14,505
U.S. Agencies	62,106	14	(96)	(260)	61,764
Collateralized mortgage obligations	16,969	294		(326)	16,937
Mortgage pass-through securities	38,851	77		(1,129)	37,799

Obligations of states and political subdivisions	492,640	13,833	(118)	(10)	506,345
Corporate bonds	66,943	1,375	(5)	(1,059)	67,254
Non-agency collateralized mortgage obligations	37,069	210		(817)	36,462
Other asset-backed securities:					
Second mortgages/home equity loans	20,925		(26)	(150)	20,749
Credit card receivables	17,230	211			17,441
Other	5,613	62		(140)	5,535
Total fixed income securities	773,178	16,076	(245)	(4,218)	784,791
Equity securities	1,508	160			1,668
Total	$ 774,686	$ 16,236	$ (245)	$ (4,218)	$ 786,459

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

Table of Contents

During the second quarter of 2007, the Company recognized impairment losses on 13 fixed income securities of various categories of investments that were in an unrealized loss position. In response to the significant change in interest rates in the second quarter, as well as a revised outlook on future interest rates, the Company does not have the intention of holding these securities to their anticipated recovery. The other-than-temporary impairment losses on these securities were $0.9 million. No other-than-temporary impairments were recorded for the three or six months ended June 30, 2006.

As of June 30, 2007, 92 securities held by the Company were in an unrealized loss position. The Company believes that 90 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 90 securities, 63 were rated AAA by Standard & Poor s (S&P) and Aaa by Moody s Investor Services (Moody s) and all were investment grade. Also, 12 of these 90 securities were in a loss position that exceeded 5% of its book value, with the largest percentage unrealized loss being 7.7% of that security s book value resulting in an unrealized loss of $0.1 million. The largest unrealized loss was $0.5 million, which was 6.9% of that security s book value.

One of the two other remaining securities 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 3.1% ($0.1 million) of its book value and was rated below investment grade by S&P and Moody s. The other security, rated above investment grade by S&P and Moody s, was issued by a large student loan provider and was in an unrealized loss position of 15.4% ($0.5 million) of its book value. The Company believes that the financial condition and near-term prospects of these issuers are strong, and expects that these unrealized losses will reverse.

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

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

3. REINSURANCE

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

	Three Months Ended June 30,			
	2007		**2006**	
	Written	**Earned**	**Written**	**Earned**
Direct	$ 95,192	$ 87,950	$ 87,594	$ 79,836
Assumed	30,747	27,985	31,720	28,693
Ceded	(9,724)	(10,248)	(10,117)	(11,488)
	$ 116,215	$ 105,687	$ 109,197	$ 97,041

	Six Months Ended June 30,			
	2007		**2006**	
	Written	**Earned**	**Written**	**Earned**
Direct	$ 187,747	$ 168,624	$ 173,352	$ 155,057
Assumed	56,606	55,867	58,691	55,970
Ceded	(19,363)	(20,501)	(20,940)	(22,098)
	$ 224,990	$ 203,990	$ 211,103	$ 188,929

Assumed premiums primarily includes all surety business written or renewed, net of reinsurance, by CCC and CIC, and their affiliates, after September 30, 1997 that is reinsured by Western Surety pursuant to reinsurance and related

agreements. Because of certain regulatory restrictions that limit the Company s ability to write business on a direct basis, the Company continues to utilize the underwriting capacity available through these agreements. The Company is in full control of all aspects of the underwriting and claim management of the business assumed from affiliates.

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

	Three Months Ended June 30,			
	2007		2006	
	$	Ratio	$	Ratio
Gross losses and loss adjustment expenses	$ 30,280	26.1%	$ 28,328	26.1%
Ceded amounts	(3,426)	33.4%	(3,383)	29.4%
Net losses and loss adjustment expenses	$ 26,854	25.4%	$ 24,945	25.7%

	Six Months Ended June 30,			
	2007		2006	
	$	Ratio	$	Ratio
Gross losses and loss adjustment expenses	$ 58,573	26.1%	$ 55,182	26.1%
Ceded amounts	(6,776)	33.1%	(6,641)	30.1%
Net losses and loss adjustment expenses	$ 51,797	25.4%	$ 48,541	25.7%

2007 THIRD PARTY REINSURANCE COMPARED TO 2006 THIRD PARTY REINSURANCE

Effective January 1, 2007, CNA Surety entered into a new excess of loss treaty (2007 Excess of Loss Treaty) with a group of third party reinsurers on terms similar to the 2006 Excess of Loss Treaty. Under the 2007 Excess of Loss Treaty, the Company s net retention per principal remained at $10 million with a 5% co-participation in the $90 million layer of third party reinsurance coverage above the Company s retention. The contract 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 2007 on bonds that were in force during 2007. The primary difference between the 2007 Excess of Loss Treaty and the Company s 2006 Excess of Loss Treaty is as follows. The base annual premium for the 2007 Excess of Loss Treaty is $36.6 million compared to the actual cost of the 2006 Excess of Loss Treaty of $39.9 million. Only the large national contractor that was excluded from the 2006 treaty remained excluded from the 2007 Excess of Loss Treaty.

RELATED PARTY REINSURANCE

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

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, 2007 and expires on December 31, 2007 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, 2007 and expires on December 31, 2007 and is annually renewable thereafter. CCC and CIC transfer the related liabilities of such business and pay to Western Surety an amount in cash equal to CCC s and CIC s net written premiums written on all such business, minus a quarterly ceding commission to be retained by CCC and CIC equal to $50,000 plus 25% of net written premiums written on all such business. This contemplates an approximate 4% override commission for fronting fees to CCC and CIC on their actual direct acquisition costs.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of the Merger Date by agreeing to pay Western Surety, within 30 days following the end of each calendar quarter, the amount of any adverse development on such reserves, as re-estimated as of the end

of such calendar quarter. There was no adverse reserve development for the period from the Merger Date through June 30, 2007.

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 June 30, 2007, the Company had billed and received $47.6 million under the Stop Loss Contract. The amount received under the Stop Loss Contract included $29.9 million held by the Company for losses covered by this contract that were incurred but not paid as of June 30, 2007. As of December 31, 2006, the Company had billed $47.9 million and had 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 was ceded under this contract. In the second quarter of 2005, this contract was amended to provide unlimited coverage in excess of the $60 million retention, to increase the premium to $7.0 million, and to eliminate the additional premium provision. This treaty provides coverage for the life of bonds either in force or written during the term of the treaty which was from January 1, 2005 to December 31, 2005. In November 2005, the Company and CCC agreed by addendum to extend this contract for twelve months. This extension, which expired on December 31, 2006, was for an additional minimum premium of $0.8 million, subject to adjustment based on the level of actual premiums written on bonds for the large national contractor. In January 2007, the Company and CCC agreed by addendum to extend this contract for another twelve months. This extension, which will expire on December 31, 2007, was for an additional premium subject to the level of actual premiums written on bonds for the large national contractor. As of June 30, 2007 and December 31, 2006, the Company had ceded losses of $50.0 million under the terms of this contract.

As of June 30, 2007 and December 31, 2006, CNA Surety had an insurance receivable balance from CCC and CIC of $66.0 million and $61.9 million, respectively. CNA Surety had a reinsurance payable of $0.1 million to CCC and CIC as of June 30, 2007. CNA Surety had no reinsurance payables to CCC and CIC as of December 31, 2006.

4. RESERVES FOR LOSSES AND LOSS ADJUSTMENT EXPENSES

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2007	**2006**	**2007**	**2006**
Reserves at beginning of period:				
Gross	$ 431,974	$ 426,181	$ 434,224	$ 424,449
Ceded reinsurance	143,676	150,003	144,858	147,435
Net reserves at beginning of period	288,298	276,178	289,366	277,014
Net incurred loss and loss adjustment expenses:				
Provision for insured events of current period	26,878	25,071	51,847	48,708
Decrease in provision for insured events of prior periods	(24)	(126)	(50)	(167)
Total net incurred	26,854	24,945	51,797	48,541
Net payments attributable to:				
Current period events	3,299	1,141	5,574	1,551
Prior period events	19,260	19,494	42,996	43,516
Total net payments	22,559	20,635	48,570	45,067

Net reserves at end of period	292,593	280,488	292,593	280,488
Ceded reinsurance at end of period	142,976	155,237	142,976	155,237
Gross reserves at end of period	$ 435,569	$ 435,725	$ 435,569	$ 435,725

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 provided an aggregate of up to $50.0 million in borrowings under a revolving credit facility. In the third quarter of 2006, the outstanding 2005 Credit Facility balance of $20.0 million was paid. Also, in September 2006, the Company reduced the available aggregate revolving credit facility to $25.0 million in borrowings. 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 utilization fee, can vary based on the Company s leverage ratio (debt to total capitalization) from

0.80% to 1.00%. There was no outstanding balance under the 2005 Credit Facility during the three and six months ended June 30, 2007. As such, the Company paid only the facility fee of 0.325% at June 30, 2007. As of June 30, 2006, the weighted average interest rate was 6.625% 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 as of and for the three and six months ended June 30, 2007.

In May 2004, the Company, through a wholly-owned trust, privately issued $30.0 million of preferred securities through two pooled transactions. These securities bear interest at a rate of LIBOR plus 337.5 basis points with a 30-year term and are redeemable at par value after five years. The securities were issued by CNA Surety Capital Trust I (the Issuer Trust). The Company s investment of $0.9 million in the Issuer Trust is carried at cost in Other assets in the Company s Condensed Consolidated Balance Sheet. The sole asset of the Issuer Trust consists of a $30.9 million junior subordinated debenture issued by the Company to the Issuer Trust. The Company has also guaranteed the dividend payments and redemption of the preferred securities issued by the Issuer Trust. The maximum amount of undiscounted future payments the Company could make under the guarantee is $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 2034. As of June 30, 2007 and 2006, the interest rate on the junior subordinated debenture was 8.735% and 8.545%, respectively.

6. EMPLOYEE BENEFITS

Western Surety sponsors two postretirement benefit plans covering certain employees. One plan provides medical benefits, and the other plan provides sick leave termination payments. The 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):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Net periodic benefit cost:				
Service cost	$ 77	$ 74	$ 153	$ 148
Interest cost	173	143	346	286
Prior service cost	(40)	(39)	(81)	(80)
Recognized net actuarial loss	81	62	163	125
Net periodic benefit cost	$ 291	$ 240	$ 581	$ 479

As a result of adopting SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS 158) as of December 31, 2006, amortization of prior service costs and net actuarial (gains)/losses recognized through the statement of income for the six months ended June 30, 2007 are also adjusted through other comprehensive income.

The Company expects to contribute $0.3 million to the postretirement benefit plans to pay benefits in 2007. As of June 30, 2007, $0.2 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 $0.5 million and $0.3 million for the three months ended June 30, 2007 and 2006, respectively, and $1.0 million and $0.6 million for the six months ended June 30, 2007 and 2006, respectively. The total income tax benefit recognized in the statement of income for stock-based compensation arrangements was $0.1 million and $0.1 million for the three months ended June 30, 2007 and 2006, respectively, and $0.3 million and $0.2 million for the six months ended June 30, 2007 and 2006, respectively . The amount of cash received from the exercise of stock options was $0.2 million and $1.6 million for the three months ended June 30, 2007 and 2006, respectively, and $1.8 million and $4.8 million for the six months ended June 30, 2007 and 2006, respectively.

EQUITY COMPENSATION PLANS

The Company previously 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). Option exercises under the 1997 Plan were settled in newly issued common shares. No options were granted under the 1997 Plan during the three or six months ended June 30, 2006.

The Company s 2006 Long-Term Equity Compensation Plan (the 2006 Plan), approved by shareholders on April 25, 2006, replaced the 1997 Plan. Incentive stock options, non-qualified stock options, restricted stock, bonus shares, or SARs may be granted to directors, officers, employees and certain advisors of the Company under the 2006 Plan. The aggregate number of shares initially available for which options may be granted under the 2006 Plan was 3,000,000. Option exercises under the 2006 Plan are settled in newly issued common shares.

The 2006 Plan is administered by a committee (the Committee) of the Board of Directors, consisting of two or more directors of the Company. Subject to the provisions set forth in the 2006 Plan, all of the members of the Committee shall be independent members of the Board of Directors. The Committee determines the option exercise prices. Exercise prices may not be less than the fair market value of the Company s common stock on the date of grant for incentive stock options and may not be less than the par value of the Company s common stock for non-qualified stock options.

The 2006 Plan provides for the granting of incentive stock options as defined under Section 382 of the Internal Revenue Code of 1986, as amended. All non-qualified stock options and incentive stock options granted under the 2006 Plan expire ten years after the date of grant and vest ratably over the four-year period following the date of grant.

On February 13, 2007, 334,100 options were granted under the 2006 Plan. The fair market value (at grant date) per option granted was $9.04 for these options. The fair value of these options was estimated at grant date using a Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate of 4.8%; dividend yield of 0.0%; expected option life of 6.3 years; and volatility of 34.7%. As of June 30, 2007, the number of shares available for granting of options under the 2006 Plan was 2,668,300.

A summary of option activity for the six months ended June 30, 2007 and 2006 is presented below:

	Shares Subject To Option	Weighted Average Exercise Price Per Share
Outstanding options at January 1, 2006	1,587,909	$ 12.41
Options granted		$
Options forfeited	(9,500)	$ 12.00
Options expired	(20,875)	$ 14.07
Options exercised	(337,034)	$ 13.09
Outstanding options at June 30, 2006	1,220,500	$ 12.19

Outstanding options at January 1, 2007	1,008,525	$	12.02
Options granted	334,100	$	20.70
Options forfeited	(19,175)	$	13.32
Options expired	(590)	$	14.97
Options exercised	(114,010)	$	12.18
Outstanding options at June 30, 2007	1,208,850	$	14.38

A summary of the status of the Company s non-vested options as of June 30, 2007 and 2006 and changes during the six months then ended is presented below:

	Shares Subject To Option	Weighted Average Grant Date Fair Value
Non-vested options at January 1, 2006	785,845	$ 4.40
Options granted		
Options vested	(12,875)	$ 3.72
Options forfeited	(9,500)	$ 4.48
Non-vested options at June 30, 2006	763,470	$ 4.41
Non-vested options at January 1, 2007	481,613	$ 4.51
Options granted	334,100	$ 9.04
Options vested	(12,875)	$ 3.72
Options forfeited	(19,175)	$ 5.13
Non-vested options at June 30, 2007	783,663	$ 6.44

A summary of the options vested or expected to vest and options exercisable as of June 30, 2007 is presented below:

	Options Vested or Expected to Vest			
	Number	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
June 30, 2007	1,125,505	$ 14.01	$5,999,178	7.3 years

	Options Exercisable			
	Number	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
June 30, 2007	425,187	$ 11.67	$3,079,849	5.4 years

The total intrinsic value of options exercised was $0.1 million and $0.5 million for the three months ended June 30, 2007 and 2006, respectively, and $1.1 million and $1.3 million for the six months ended June 30, 2007 and 2006, respectively. The tax benefits recognized by the Company for these exercises were $0.1 million and $0.3 million for the three months ended June 30, 2007 and 2006, respectively. Tax benefits recognized by the Company were $0.4 million for both the six months ended June 30, 2007 and 2006.

As of June 30, 2007, there was $2.5 million of total unrecognized compensation cost related to non-vested stock-based compensation arrangements granted under the Company s equity compensation plans. That cost is expected to be recognized as follows: 2007 $0.9 million; 2008 $1.0 million; 2009 $0.4 million; and 2010 $0.2 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, 2006.

CRITICAL ACCOUNTING POLICIES

Management believes the most significant accounting policies and related disclosures for purposes of understanding the Company s results of operations and financial condition pertain to reserves for unpaid losses and loss adjustment expenses and reinsurance, investments, goodwill and other intangible assets, recognition of premium revenue and the related unearned premium liability, and deferred policy acquisition costs. The Company s accounting policies related to reserves for unpaid losses and loss adjustment expenses and related estimates of reinsurance recoverables are particularly critical to an assessment of the Company s

financial results. Given the nature of the surety business, the determination of these balances is inherently a highly subjective exercise, which requires management to analyze, weigh, and balance numerous macroeconomic, customer specific, and claim specific factors and trends, most of which, in themselves, are inherently uncertain and difficult to predict.

RESERVES FOR UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES AND REINSURANCE

CNA Surety accrues liabilities for unpaid losses and loss adjustment expenses (LAE) under its surety and property and casualty insurance contracts based upon estimates of the ultimate amounts payable under the contracts related to losses occurring on or before the balance sheet date.

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

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

As of any balance sheet date, not all claims have been reported and some claims may not be reported for many years. As a result, the liability for unpaid losses includes significant estimates for incurred-but-not-reported (IBNR) claims. The IBNR reserves include provisions for losses in excess of the current case reserve for previously reported claims and for claims that may be reopened. The IBNR reserves also include offsets for anticipated salvage and subrogation recoveries. The following table shows the estimated liability as of June 30, 2007 for unpaid claims applicable to reported claims and to IBNR for each sub-line of business (dollars in thousands):

	Gross Case Loss and LAE Reserves	Gross IBNR Loss and LAE Reserves	Total Gross Reserves
Contract	$ 121,482	$ 147,511	$ 268,993
Commercial	102,136	53,042	155,178
Fidelity and other	3,565	7,833	11,398
Total	$ 227,183	$ 208,386	$ 435,569

The Company retains an independent actuarial firm of national standing to perform periodic actuarial analyses of the Company s loss reserves. These analyses typically include a comprehensive review performed in the third quarter based on data as of June 30 and an update of the comprehensive review performed in January based on data as of December 31. In between these analyses, management monitors claim activity against benchmarks prepared by the independent actuarial firm based on expected claim activity and consults with the actuarial firm as necessary.

The independent actuarial firm s analyses are based upon multiple projection methodologies that involve detailed statistical analysis of past claim reporting, settlement activity, and salvage and subrogation activity, as well as claim frequency and severity data when sufficient information exists to lend statistical credibility to the analysis. The

analysis may be based upon internal loss experience or industry experience. Methodologies may vary depending on the type of claim being estimated. While methodologies may vary, each employs significant judgments and assumptions.

Each of the projection methodologies employed rely to varying degrees on the basic assumption that the Company s historical claim experience is indicative of the Company s future claim development. The amount of weight given to any individual projection method is based on an assessment of the volatility of the historical data and development patterns, an understanding of the changes in the overall surety industry over time and the resultant potential impact of these changes on the Company s prospective claims development, an understanding of the changes to the Company s processes and procedures within its underwriting, claims handling

16

and data systems functions, among other things. The decision as to how much weight to give to any particular projection methodology is ultimately a matter of experience and professional judgment.

Surety results, especially for contract and certain commercial products like insurance program bonds, workers compensation insurance bonds and reclamation bonds, tend to be impacted by fewer, but more severe, losses. With this type of loss experience, it is more difficult to estimate the required reserves, particularly for the most current accident years which may have few reported claims. Therefore, assumptions related to the frequency and magnitude of severe loss are key in estimating surety loss reserves. The Company experienced a period of unusually high frequency of severe loss in accident years 2002 and 2003. In response to this activity, the independent actuarial firm included higher expectations of severe losses in its analysis for 2004. The Company s claim experience improved dramatically since 2004. As a result, the independent actuarial firm s current analysis places less reliance on the severe loss experience in accident years 2002 and 2003.

The indicated reserve was developed by reviewing the Company s claims experience by accident year for several individual sub-lines of business. Within each sub-line, the selection of the point estimate was made after consideration of the appropriateness of the various projection methodologies in light of the sub-line s loss characteristics and historical data. In general, for the older, more mature, accident years the historical development method (i.e., link ratio method) was relied upon more heavily. For the more recent years, the indicated reserves were more heavily based on the Bornhuetter-Ferguson and loss ratio methods since these are not as reliant on the Company s large (i.e., leveraged) development factors and thus are believed to represent a more stable set of methods from which to select indicated reserves for the more recent years.

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

- Current claim activity, including the frequency and severity of current claims;
- Changes in underwriting standards and business mix such as the Company s efforts to reduce exposures to large commercial bonds;
- Changes in the claims handling process; and
- Current economic conditions, especially corporate default rates and the condition of the construction economy.

Management believes that the impact of the factors listed above, and others, may not be fully quantifiable through actuarial analysis. Accordingly, management may apply its judgment of the impact of these factors, and others, to its selection of the recorded loss reserves.

At December 31, 2006, management s recorded gross and net reserves were slightly lower than the point estimate determined by the independent actuarial firm, with the percentage difference being somewhat larger on a net basis. At December 31, 2006, management believed continued improvement in economic conditions, lower corporate default rates and fewer reported severe claims indicated a lower provision for severe losses was appropriate. Management believed that the actuarial point estimates included provisions in the most recent accident year for severe losses that continue to be influenced by the Company s experience in accident

years 2002 and 2003 and did not fully reflect the favorable economic conditions, changes in the Company s exposures and favorable claim experience during the most recent accident years.

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.

Casualty insurance loss reserves are subject to a significant amount of uncertainty. Given the nature of surety losses with its low frequency, high severity characteristics, this is particularly true for surety loss reserves. As a result, the range of reasonable loss reserve estimates may be broader than that associated with traditional property/casualty insurance products. While the loss reserve estimates represent the best professional judgments, arrived at after careful actuarial analysis of the available data, it is important to note that variation from the estimates is not only possible but, in fact, probable. The degree of such variation could be significant and in either direction from the estimates and could result in actual losses outside of the estimated reserve range. The sources of this inherent variability are numerous future economic conditions, court decisions, legislative actions, and individual large claim impacts, for example.

The range of reasonable reserve estimates is not intended to reflect the maximum and/or minimum possible outcomes; but rather reflects a range of reasonable estimates given the uncertainty in estimating unpaid claim liabilities for surety business. Further, there is no generally accepted method to estimating reserve ranges, but rather many concepts are currently being vetted within actuarial literature.

In developing the indicated range of reserve estimates for the Company, the independent actuarial firm utilized the Mack methodology and their point estimate analysis in order to estimate the requisite reserve distribution parameters. The Mack methodology is premised on the idea that the volatility in a company s historical paid loss development is representative of the variability in a company s future payments and thus can be used to estimate the variability within a company s reserve estimate. Given the dispersion of the reserve indications, along with its experience and professional judgment, the independent actuarial firm selected the 50th and 75th percentile as representing a reasonable range of reserve estimates.

At December 31, 2006, the range of reasonable loss reserve estimates, net of reinsurance receivables, calculated by the independent actuarial firm and adopted by management was from $247 million to $353 million. Ranges of reasonable loss reserve estimates are not calculated for the sub-lines of business. Management believes that the range calculated over total reserves provides the most meaningful information due to the importance of correlation of losses between the sub-lines of business related to the impact of general economic conditions.

The primary factors that would result in the Company s actual losses being closer to either end of the reserve range is the emergence of (or lack thereof) a small number of large claims, as well as the recovery of (or lack thereof) a small number of large salvage/subrogation amounts. In other words, the primary factors that, if they were to occur, would result in the Company s actual payments being at the high end of the indicated range are if the Company experiences an unusually high number of large claims and/or an unusually low number of large salvage and subrogation recoveries. Conversely, if the Company were to experience an unusually low number of large claims and/or an unusually high number of large salvage and subrogation recoveries, the Company s actual payments would tend to be at the low end of the range. These variations in outcomes could be driven by broader issues such as the state of the construction economy or the level of corporate defaults, or by the specific facts and circumstances surrounding individual claims. Again, it is important to note that it is possible that the actual payments could fall outside of the estimated range.

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

INVESTMENTS

Management believes the Company has the ability to hold all fixed income securities to maturity. However, the Company may dispose of securities prior to their scheduled maturity due to changes in interest rates, prepayments, tax

and credit considerations, liquidity or regulatory capital requirements, or other similar factors. As a result, the Company classifies all of its fixed income securities (bonds and redeemable preferred stocks) and equity securities as available-for-sale. These securities are reported at fair

---

value, with unrealized gains and losses, net of deferred income taxes, reported in stockholders equity as a separate component of accumulated other comprehensive income. Cash flows from purchases, sales and maturities are reported gross in the investing activities section of the Condensed Consolidated Statements of Cash Flows.

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

Short-term investments, which generally include U.S. Treasury bills, corporate notes, money market funds, and investment grade commercial paper are carried at amortized cost that approximates fair value. Invested assets are exposed to various risks, such as interest rate risk, market risk and credit risk. Due to the level of risk associated with invested assets and the level of uncertainty related to changes in the value of these assets, it is possible that changes in risks in the near term may significantly affect the amounts reported in the Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Income.

INTANGIBLE ASSETS

CNA Surety s Condensed Consolidated Balance Sheet as of June 30, 2007 and December 31, 2006 includes intangible assets of approximately $138.8 million. These amounts represent goodwill and identified intangibles arising from the acquisition of Capsure Holdings Corp.

A significant amount of judgment is required in performing intangible asset impairment tests. Such tests are performed annually on October 1, or more frequently if events or changes indicate that the estimated fair value of an intangible asset 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. Contract bonds provide coverage for the length of the bonded project and not a fixed time period. As such, the Company uses estimates of the contract length as the basis for recognizing premium revenue on these bonds. Premium revenues are net of amounts ceded to reinsurers. Unearned premiums represent the portion of premiums written, before ceded reinsurance which is shown as an asset, applicable to the unexpired terms of policies in force determined on a pro rata basis.

DEFERRED POLICY 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.

Table of Contents

RESULTS OF OPERATIONS
FINANCIAL MEASURES

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

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

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

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

COMPARISON OF CNA SURETY RESULTS FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006
ANALYSIS OF NET INCOME

Net income for the three months ended June 30, 2007 was $21.9 million, or $0.50 per diluted share, compared to $19.5 million, or $0.45 per diluted share, for the same period in 2006. The increase in net income reflects higher earned premium, higher investment income, and the impacts of lower loss and expense ratios. The components of net income are discussed in the following sections.

Net income for the six months ended June 30, 2007 was $42.6 million, or $0.96 per diluted share, compared to $37.5 million, or $0.86 per diluted share, in 2006. The increase in net income reflects higher earned premium, higher investment income, and the impacts of lower loss and expense ratios.

Table of Contents

RESULTS OF INSURANCE OPERATIONS

Underwriting components for the Company for the three and six months ended June 30, 2007 and 2006 are summarized in the following table (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Gross written premiums	$ 125,939	$ 119,314	$ 244,353	$ 232,043
Net written premiums	$ 116,215	$ 109,197	$ 224,990	$ 211,103
Net earned premiums	$ 105,687	$ 97,041	$ 203,990	$ 188,929
Net losses and loss adjustment expenses	$ 26,854	$ 24,945	$ 51,797	$ 48,541
Net commissions, brokerage and other expenses	$ 57,020	$ 53,514	$ 110,918	$ 104,427
Loss ratio	25.4%	25.7%	25.4%	25.7%
Expense ratio	54.0	55.1	54.4	55.3
Combined ratio	79.4%	80.8%	79.8%	81.0%

PREMIUMS WRITTEN/EARNED

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

The Company assumes significant amounts of premiums primarily from affiliates. This includes all surety business written or renewed, net of reinsurance, by Continental Casualty Company (CCC) and The Continental Insurance Company (CIC), and their affiliates, after September 30, 1997 (the Merger Date) that is reinsured by Western Surety Company (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):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Contract	$ 84,873	$ 78,758	$ 158,016	$ 146,202
Commercial	33,457	33,017	69,687	68,872
Fidelity and other	7,609	7,539	16,650	16,969

	$ 125,939	$ 119,314	$ 244,353	$ 232,043

For the quarter ended June 30, 2007, gross written premiums increased 5.6 percent to $125.9 million as compared to the quarter ended June 30, 2006. Gross written premiums for contract surety increased 7.8 percent to $84.9 million primarily due to steady demand as a result of the strong construction economy and the success of the Company s small contractor product. Large and small commercial surety gross written premiums, as well as related fidelity and other gross written premiums, increased slightly for the quarter.

For the six months ended June 30, 2007, gross written premiums increased 5.3 percent to $244.4 million as compared to the six-month period ended June 30, 2006. Gross written premiums for contract surety increased 8.1 percent to $158.0 million primarily due to steady demand as a result of the strong construction economy and the success of the Company s small contractor product. Both large and small commercial surety gross written premiums increased slightly for the first half of 2007. Fidelity and other premiums decreased by 1.9% due to the lingering effects of the loss of a large notary program in the first quarter of 2006.

Table of Contents

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Contract	$ 76,073	$ 69,691	$ 140,520	$ 127,403
Commercial	32,533	31,967	67,820	66,731
Fidelity and other	7,609	7,539	16,650	16,969
	$ 116,215	$ 109,197	$ 224,990	$ 211,103

For the quarter ended June 30, 2007, net written premiums increased 6.4 percent to $116.2 million as compared to the second quarter of 2006, primarily due to the increase in gross written premiums as described above.

For the six months ended June 30, 2007, net written premiums increased 6.6 percent to $225.0 million, primarily due to the increase in gross written premiums described above and a decrease in ceded written premiums. Ceded written premiums decreased $1.6 million to $19.4 million for the first six months of 2007 compared to the same period last year. This decrease reflects lower costs for reinsurance for a specific account and savings on the core reinsurance program.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Contract	$ 65,446	$ 56,478	$ 123,942	$ 108,493
Commercial	32,380	32,068	64,383	63,413
Fidelity and other	7,861	8,495	15,665	17,023
	$ 105,687	$ 97,041	$ 203,990	$ 188,929

For the quarter ended June 30, 2007, net earned premiums increased 8.9 percent to $105.7 million as compared to the second quarter of 2006, primarily due to the increase in gross written premiums as described above.

For the six months ended June 30, 2007, net earned premiums increased 8.0 percent to $204.0 million, primarily due to the increase in gross written premiums and the decrease in ceded written premiums described above.

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.

2007 THIRD PARTY REINSURANCE COMPARED TO 2006 THIRD PARTY REINSURANCE

Effective January 1, 2007, CNA Surety entered into a new excess of loss treaty (2007 Excess of Loss Treaty) with a group of third party reinsurers on terms similar to the 2006 Excess of Loss Treaty. Under the 2007 Excess of Loss Treaty, the Company s net retention per principal remained at $10 million with a 5% co-participation in the $90 million layer of third party reinsurance coverage above the Company s retention. The contract 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 2007 on bonds that were in force during 2007. The primary difference between the 2007 Excess of Loss Treaty and the Company s 2006 Excess of Loss Treaty is as follows. The base annual premium for the 2007 Excess of Loss Treaty is $36.6 million compared to the actual cost of the 2006 Excess of Loss Treaty of $39.9 million. Only the large national contractor that was excluded from the 2006 treaty remained excluded from the 2007 Excess of Loss Treaty.

RELATED PARTY REINSURANCE

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

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, 2007 and expires on December 31, 2007 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 the Merger Date. The Quota Share Treaty was renewed on January 1, 2007 and expires on December 31, 2007 and is annually renewable thereafter. CCC and CIC transfer the related liabilities of such business and pay to Western Surety an amount in cash equal to CCC s and CIC s net written premiums written on all such business, minus a quarterly ceding commission to be retained by CCC and CIC equal to $50,000 plus 25% of net written premiums written on all such business. This contemplates an approximate 4% override commission for fronting fees to CCC and CIC on their actual direct acquisition costs.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of the Merger Date by agreeing to pay Western Surety, within 30 days following the end of each calendar quarter, the amount of any adverse development on such reserves, as re-estimated as of the end of such calendar quarter. There was no adverse reserve development for the period from the Merger Date through June 30, 2007.

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 June 30, 2007, the Company had billed and received $47.6 million under the Stop Loss Contract. This amount received under the Stop Loss Contract included $29.9 million held by the Company for losses covered by this contract that were incurred but not paid as of June 30, 2007. As of December 31, 2006, the Company had billed $47.9 million and had 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 was ceded under this contract. In the second quarter of 2005, this contract was amended to provide unlimited coverage in excess of the $60 million retention, to increase the premium to $7.0 million, and to eliminate the additional premium provision. This treaty provides coverage for the life of bonds either in force or written during the term of the treaty which was from January 1, 2005 to December 31, 2005. In November 2005, the Company and CCC agreed by addendum to extend this contract for twelve months. This extension, which expired on December 31, 2006, was for an additional minimum premium of $0.8 million, subject to adjustment based on the level of actual premiums written on bonds for the large national contractor. In January 2007, the Company and CCC agreed by addendum to extend this contract for another twelve months. This extension, which will expire on December 31, 2007, was for an additional premium subject to the level of actual premiums written on bonds for the large national contractor. As of June 30, 2007 and December 31, 2006, the Company had ceded losses of $50.0 million under the terms of this contract.

As of June 30, 2007 and December 31, 2006, CNA Surety had an insurance receivable balance from CCC and CIC of $66.0 million and $61.9 million, respectively. CNA Surety had a reinsurance payable of $0.1 million to CCC and CIC as of June 30, 2007. CNA Surety had no reinsurance payables to CCC and CIC as of December 31, 2006.

EXPOSURE MANAGEMENT

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

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

Table of Contents

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

NET LOSS RATIO

The net loss ratio was 25.4% for the three and six months ended June 30, 2007 as compared with 25.7% for the same periods in 2006. The improvement in this ratio reflects lower reinsurance costs.

EXPENSE RATIO

The expense ratio was 54.0% for the three months ended June 30, 2007 as compared with 55.1% for the same period in 2006. The expense ratio was 54.4% for the six months ended June 30, 2007 as compared with 55.3% for the same period in 2006. The improvement in the ratio reflects earned premium growth as discussed above and continued focus on expense management.

INVESTMENT INCOME AND REALIZED INVESTMENT GAINS/LOSSES

Net investment income was $10.8 million for the three months ended June 30, 2007, as compared with $10.0 million for the same period in 2006. This increase is due to higher overall invested assets and higher yields. The annualized pre-tax yield was 4.6% and 4.5% for the three months ended June 30, 2007 and 2006, respectively. The annualized after-tax yield was 3.8% and 3.7% for the three months ended June 30, 2007 and 2006, respectively. Net realized investment losses were $0.8 million for the quarter ended June 30, 2007 compared to net realized investment gains of $0.1 million in the same period of 2006.

Net investment income was $21.5 million for the six months ended June 30, 2007 as compared with $19.2 million for the same period in 2006. The increase is due to the impact of higher overall invested assets and higher yields. The annualized pre-tax yields were 4.6% and 4.5% for the six months ended June 30, 2007 and 2006, respectively. The annualized after-tax yields were 3.8% and 3.7% for the six months ended June 30, 2007 and 2006, respectively. Net realized investment losses were $0.6 million for the first six months of 2007 compared to net realized investment gains of $0.1 million in the same period of 2006.

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2007	**2006**	**2007**	**2006**
Gross realized investment gains	$ 112	$ 95	$ 391	$ 114
Gross realized investment losses	(942)	(8)	(942)	(9)
Net realized investment gains	$ (830)	$ 87	$ (551)	$ 105

The gross realized investment losses for the three and six months ended June 30, 2007 resulted from impairment of certain fixed income securities which are discussed in the Financial Condition section of this MD&A.

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

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

INTEREST EXPENSE

Interest expense decreased by 28.1% for the three months ended June 30, 2007 as compared with the same period in 2006, due to a reduction in weighted average debt outstanding during 2006. Weighted average debt outstanding was $30.9 million for the three

24

months ended June 30, 2007 as compared with $50.9 million for the same period in 2006. The weighted average interest rate for the three months ended June 30, 2007 was 8.7% as compared with 7.5% for the same period in 2006.

Interest expense decreased by 26.2% for the six months ended June 30, 2007 as compared with the same period in 2006. Weighted average debt outstanding was $30.9 million for the six months ended June 30, 2007 compared to $50.9 million in the same period in 2006. The weighted average interest rate for the six months ended June 30, 2006 was 8.7% as compared with 7.3% for the same period in 2006.

INCOME TAXES

For the three and six months ended June 30, 2007 and 2006, respectively, the Company s effective tax rate differs from the statutory tax rate due primarily to tax-exempt investment income. Tax-exempt investment income was $5.1 million and $9.9 million for the three and six months ended June 30, 2007. Tax-exempt investment income was $4.5 million and $8.8 million for the three and six months ended June 30, 2006.

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 June 30, 2007, the carrying value of the Company s insurance subsidiaries invested assets was comprised of $850.3 million of fixed income securities, $53.2 million of short-term investments and $1.0 million of cash. At December 31, 2006, the carrying value of the Company s insurance subsidiaries invested assets was comprised of $784.0 million of fixed income securities, $94.2 million of short-term investments and $3.5 million of cash.

Cash flow at the parent company level is derived principally from dividend and tax sharing payments from its insurance subsidiaries. The principal obligations at the parent company level are to service debt and pay operating expenses, including income taxes. At June 30, 2007, the parent company s invested assets consisted of $0.7 million of fixed income securities, $1.9 million of equity securities, and $4.6 million of short-term investments and cash. At December 31, 2006, the parent company s invested assets consisted of $0.8 million of fixed income securities, $1.7 million of equity securities, and $12.4 million of short-term investments and cash. At June 30, 2007 and December 31, 2006 respectively, parent company short-term investments and cash included $3.5 million and $9.4 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 $19.2 million for the three months ended June 30, 2007 compared to net cash flow provided by operating activities of $23.4 million for the comparable period in 2006. The decrease in net cash flow provided by operating activities relates to larger loss payments and larger estimated tax payments.

The Company s consolidated net cash flow provided by operating activities was $33.1 million for the six months ended June 30, 2007 compared to net cash flow provided by operating activities of $37.6 million for the comparable period in 2006. The decrease in net cash flow provided by operating activities primarily relates to larger 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 provided an aggregate of up to $50.0 million in borrowings under a revolving credit facility. In the third quarter of 2006, the outstanding 2005 Credit Facility balance of $20.0 million was paid. Also, in September 2006, the Company reduced the available aggregate revolving credit facility to $25.0 million in borrowings. 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

25

Table of Contents

margin. The margin, including a utilization fee, can vary based on the Company s leverage ratio (debt to total capitalization) from 0.80% to 1.00%. There was no outstanding balance under the 2005 Credit Facility during the three and six months ended June 30, 2007. As such, the Company paid only the facility fee of 0.325% at June 30, 2007. As of June 30, 2006, the weighted average interest rate was 6.625% 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 as of and for the three and six months ended June 30, 2007.

In May 2004, the Company, through a wholly-owned trust, privately issued $30.0 million of preferred securities through two pooled transactions. These securities bear interest at a rate of LIBOR plus 337.5 basis points with a 30-year term and are redeemable at par value after five years. The securities were issued by CNA Surety Capital Trust I (the Issuer Trust). The Company s investment of $0.9 million in the Issuer Trust is carried at cost in Other assets in the Company s Condensed Consolidated Balance Sheet. The sole asset of the Issuer Trust consists of a $30.9 million junior subordinated debenture issued by the Company to the Issuer Trust. The Company has also guaranteed the dividend payments and redemption of the preferred securities issued by the Issuer Trust. The maximum amount of undiscounted future payments the Company could make under the guarantee is $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 2034. As of June 30, 2007 and 2006, the interest rate on the junior subordinated debenture was 8.735% and 8.545%, respectively.

A summary of the Company s commitments as of June 30, 2007 is presented in the following table (in millions):

Contractual Obligations as of June 30, 2007	**2007**	**2008**	**2009**	**2010**	**2011**	**Thereafter**	**Total**
Debt (a)	$ 1.4	$ 2.7	$ 2.7	$ 2.7	$ 2.7	$ 91.5	$ 103.7
Operating leases	1.1	1.9	1.9	1.9	1.8	0.9	9.5
Loss and loss adjustment expense reserves	131.2	132.6	87.0	26.5	18.1	40.2	435.6
Other long-term liabilities (b)	0.2	1.1	1.0	0.6	0.6	11.9	15.4
Total	$ 133.9	$ 138.3	$ 92.6	$ 31.7	$ 23.2	$ 144.5	$ 564.2

(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 Company of America (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 Universal Surety of America 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 2007 is based on statutory surplus and income at and for the year ended December 31, 2006. Without prior regulatory approval in 2007, Western Surety may pay dividends of $87.7 million to CNA Surety. CNA Surety received no dividends from its insurance subsidiaries or its non-insurance subsidiaries during the first six months of 2007 or 2006.

Table of Contents

Combined statutory surplus totaled $386.8 million at June 30, 2007, resulting in a net written premium to statutory surplus ratio of to 1.1 to 1.0. Insurance regulations restrict Western Surety s maximum net retention on a single surety bond to 10 percent of statutory surplus. Under the 2007 Excess of Loss Treaty, the Company s net retention on new bonds would generally be $10 million plus a 5% co-participation in the $90 million layer of excess reinsurance above the Company s retention. Based on statutory surplus as of June 30, 2007, this regulation would limit Western Surety s largest gross risk to $124.2 million. This surplus requirement may limit the amount of future dividends Western Surety could otherwise pay to CNA Surety.

In accordance with the provisions of intercompany tax sharing agreements between CNA Surety and its subsidiaries, the tax of each subsidiary shall be determined based upon each subsidiary s separate return liability. Intercompany tax payments are made at such times when estimated tax payments would be required by the Internal Revenue Service. CNA Surety received $18.5 million and $19.2 million from its subsidiaries for the six months ended June 30, 2007 and June 30, 2006, respectively.

Western Surety and Surety Bonding each qualify as an acceptable surety for federal and other public works project bonds pursuant to U.S. Department of Treasury regulations. U.S. Treasury underwriting limitations are based on an insurer s statutory surplus. Effective July 1, 2006 through June 30, 2007, the underwriting limitations of Western Surety and Surety Bonding were $26.8 million and $0.7 million, respectively. Effective July 1, 2007 through June 30, 2008, the underwriting limitations of Western Surety and Surety Bonding are $34.2 million and $0.7 million, respectively. Through the Quota Share Treaty previously discussed, CNA Surety has access to CCC and its affiliates U.S. Department of Treasury underwriting limitations. Effective July 1, 2006 through June 30, 2007, the underwriting limitations of CCC and its affiliates utilized under the Quota Share Treaty totaled $549.0 million. Effective July 1, 2007 through June 30, 2008, the underwriting limitations of CCC and its affiliates total $739.9 million. CNA Surety management believes that the foregoing U.S. Treasury underwriting limitations are sufficient for the conduct of its business.

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

FINANCIAL CONDITION

INVESTMENT PORTFOLIO

The estimated fair value and amortized cost or cost of fixed income and equity securities held by CNA Surety at June 30, 2007 and December 31, 2006, by investment category, were as follows (dollars in thousands):

			Gross Unrealized Losses		
June 30, 2007	**Amortized Cost or Cost**	**Gross Unrealized Gains**	**Less Than 12 Months**	**More Than 12 Months**	**Estimated Fair Value**
Fixed income securities:					
U.S. Treasury securities and obligations of U.S. Government and agencies:					
U.S. Treasury	$ 14,803	$	$	$ (392)	$ 14,411
U.S. Agencies	76,837	35	(170)	(182)	76,520
Collateralized mortgage obligations	21,192	232	(150)	(449)	20,825
Mortgage pass-through securities	35,787	45		(1,604)	34,228
Obligations of states and political subdivisions	566,317	6,296	(5,237)	(47)	567,329
Corporate bonds	56,634	759		(1,626)	55,767
Non-agency collateralized mortgage obligations	37,000	7	(20)	(1,301)	35,686
Other asset-backed securities:					
Second mortgages/home equity loans	18,483			(101)	18,382

Credit card receivables	17,232	15	(1)		17,246
Other	10,805	63		(213)	10,655
Total fixed income securities	855,090	7,452	(5,578)	(5,915)	851,049
Equity securities	1,664	236			1,900
Total	$ 856,754	$ 7,688	$ (5,578)	$ (5,915)	$ 852,949

Table of Contents

December 31, 2006	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses Less Than 12 Months	Gross Unrealized Losses More Than 12 Months	Estimated Fair Value
Fixed income securities:					
U.S. Treasury securities and obligations of U.S. Government and agencies:					
U.S. Treasury	$ 14,832	$	$	$ (327)	$ 14,505
U.S. Agencies	62,106	14	(96)	(260)	61,764
Collateralized mortgage obligations	16,969	294		(326)	16,937
Mortgage pass-through securities	38,851	77		(1,129)	37,799
Obligations of states and political subdivisions	492,640	13,833	(118)	(10)	506,345
Corporate bonds	66,943	1,375	(5)	(1,059)	67,254
Non-agency collateralized mortgage obligations	37,069	210		(817)	36,462
Other asset-backed securities:					
Second mortgages/home equity loans	20,925		(26)	(150)	20,749
Credit card receivables	17,230	211			17,441
Other	5,613	62		(140)	5,535
Total fixed income securities	773,178	16,076	(245)	(4,218)	784,791
Equity securities	1,508	160			1,668
Total	$ 774,686	$ 16,236	$ (245)	$ (4,218)	$ 786,459

The following table summarizes for fixed income securities in an unrealized loss position at June 30, 2007 and December 31, 2006 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):

	June 30, 2007		December 31, 2006	
Unrealized Loss Aging	Estimated Fair Value	Gross Unrealized Loss	Estimated Fair Value	Gross Unrealized Loss
Fixed income securities:				
Investment grade:				
0-6 months	$ 242,588	$ 5,032	$ 75,215	$ 205
7-12 months	34,362	546	10,104	40
13-24 months	104,508	4,914	137,954	3,457
Greater than 24 months	16,461	876	16,206	684
Total investment grade	397,919	11,368	239,479	4,386
Non-investment grade	3,908	125	3,960	77
Total	$ 401,827	$ 11,493	$ 243,439	$ 4,463

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 Income.

Table of Contents

During the second quarter of 2007, the Company recognized impairment losses on 13 fixed income securities of various investment categories that were in an unrealized loss position. In response to the significant change in interest rates in the second quarter, as well as a revised outlook on future interest rates, the Company does not have the intention of holding these securities to their anticipated recovery. The other-than-temporary impairment losses on these securities were $0.9 million.

As of June 30, 2007, 92 securities held by the Company were in an unrealized loss position. The Company believes that 90 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 90 securities, 63 were rated AAA by Standard & Poor s (S&P) and Aaa by Moody s Investor Services (Moody s) and all were investment grade. Also, 12 of these 90 securities were in a loss position that exceeded 5% of its book value, with the largest percentage unrealized loss being 7.7% of that security s book value resulting in an unrealized loss of $0.1 million. The largest unrealized loss was $0.5 million, which was 6.9% of that security s book value.

One of the two other remaining securities 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 3.1% ($0.1 million) of its book value and was rated below investment grade by S&P and Moody s. The other security, rated above investment grade by S&P and Moody s, was issued by a large student loan provider and was in an unrealized loss position of 15.4% ($0.5 million) of its book value. The Company believes that the financial condition and near-term prospects of these issuers are strong, and expects that these unrealized losses will reverse.

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

At June 30, 2007, the Company s exposure to sub-prime home loans was limited to four asset-backed securities with an aggregate fair value of $18.4 million. Each of these securities was rated AAA by S&P and Aaa by Moody s. Other-than-temporary impairment losses discussed above included charges for two of these securities due to the Company s lack of intention to hold these securities to their anticipated recovery. Management believes that these securities were in unrealized loss positions because of low yields and not due to credit concerns. These two securities were sold after June 30, 2007. The remaining two asset-backed securities with exposure to sub-prime home loans had an aggregate fair value of $9.9 million at June 30, 2007.

IMPACT OF PENDING ACCOUNTING STANDARDS

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159), which provides companies with an option to report selected financial assets and liabilities at fair value, with changes in fair value recorded in earnings. SFAS 159 helps to mitigate this type of accounting-induced earnings volatility by enabling companies to report related assets and liabilities at fair value, which would likely reduce the need for companies to comply with detailed rules for hedge accounting. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company s choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. SFAS 159 does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in SFAS No. 157, Fair Value Measurements (SFAS 157), discussed below, or SFAS No. 107, Disclosures about Fair Value of Financial Instruments . SFAS 159 is effective for fiscal years ending after November 15, 2007. The Company is currently evaluating the impact that adopting SFAS 159 will have on the Company s results of operations and financial condition, if any.

In September 2006, the FASB issued SFAS 157. SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with GAAP and expands disclosures about fair value measurements. SFAS 157 retains the exchange price notion in the definition of fair value and clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability. SFAS 157 emphasizes that fair value is a market-based

measurement, not an entity-specific measurement and the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. SFAS 157 expands disclosures surrounding the use of fair value to measure assets and liabilities and specifically focuses on the sources used to measure fair value. In instances of recurring use of fair value measures using unobservable inputs, SFAS 157 requires separate disclosure of the effect on earnings for the period. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within the year of adoption. The Company is currently evaluating the impact that adopting SFAS 157 will have on the Company s results of operations and financial condition, if any.

FORWARD-LOOKING STATEMENTS

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

29

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.

Table of Contents

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 June 30, 2007. 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 June 30, 2007	Hypothetical Change in Interest Rate (bp=basis points)	Estimated Fair Value After Hypothetical Change in Interest Rate	Hypothetical Percentage Increase (Decrease) in Stockholders Equity
		(Dollars in thousands)		
U.S. Government and government agencies and authorities	$ 145,984	200 bp increase	$ 133,775	(1.3)%
		100 bp increase	140,206	(0.6)
		100 bp decrease	150,407	0.5
		200 bp decrease	153,153	0.8
States, municipalities and political subdivisions	567,329	200 bp increase	501,168	(7.2)
		100 bp increase	533,500	(3.7)
		100 bp decrease	602,997	3.9
		200 bp decrease	641,594	8.0
Corporate bonds and all other	137,736	200 bp increase	127,914	(1.1)

		100 bp increase	132,699	(0.5)
		100 bp decrease	143,053	0.6
		200 bp decrease	148,625	1.2
Total fixed income securities available-for-sale	$ 851,049	200 bp increase	762,857	(9.6)
		100 bp increase	806,405	(4.8)
		100 bp decrease	896,457	5.0
		200 bp decrease	943,372	10.0

31

Table of Contents

	Fair Value at December 31, 2006	Hypothetical Change in Interest Rate (bp=basis points)	Estimated Fair Value After Hypothetical Change in Interest Rate	Hypothetical Percentage Increase (Decrease) in Stockholders Equity
		(Dollars in thousands)		
U.S. Government and government agencies and authorities	$ 131,005	200 bp increase	$ 120,310	(1.2)%
		100 bp increase	126,070	(0.6)
		100 bp decrease	134,299	0.4
		200 bp decrease	136,143	0.6
States, municipalities and political subdivisions	506,345	200 bp increase	447,610	(6.7)
		100 bp increase	476,768	(3.4)
		100 bp decrease	537,633	3.6
		200 bp decrease	571,614	7.5
Corporate bonds and all other	147,441	200 bp increase	136,456	(1.3)
		100 bp increase	141,804	(0.6)
		100 bp decrease	153,399	0.7
		200 bp decrease	159,611	1.4
Total fixed income securities available-for-sale	$ 784,791	200 bp increase	704,376	(9.2)
		100 bp increase	744,642	(4.6)
		100 bp decrease	825,331	4.7
		200 bp decrease	867,368	9.5

Table of Contents

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, 2006.

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

ITEM 3. DEFAULTS UPON SENIOR SECURITIES None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS None.

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

April 27, 2007; CNA Surety Corporation Earnings Press Release issued on April 27, 2007.

ITEM 6. EXHIBITS

	Exhibit Number
Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	31.1
Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	31.2
Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	32.1
Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	32.2

* Exhibits 32.1 and 32.2 are being furnished and shall not be deemed filed for the purpose of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the

liabilities of that Section. These Exhibits shall not be incorporated by reference into any registration statement or other document pursuant to the Securities Act of 1933, as amended.

Table of Contents

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: July 27, 2007

34

Table of Contents

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.