CNA SURETY CORP
Form 10-Q
August 13, 2001

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FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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

For the quarterly period ended JUNE 30, 2001

OR

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

Commission file number: 1-13277

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

DELAWARE	36
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer
CNA PLAZA, CHICAGO, ILLINOIS	
(Address of principal executive offices)	(Zi

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

42,755,454 shares of Common Stock, $.01 par value as of August 3, 2001.

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CNA SURETY CORPORATION AND SUBSIDIARIES

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INDEPENDENT ACCOUNTANTS' REPORT

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

We have reviewed the accompanying condensed consolidated balance sheet of CNA Surety Corporation and subsidiaries as of June 30, 2001, and the related condensed consolidated statements of income for the three-month and six-month periods ended June 30, 2001 and 2000 and the related condensed consolidated statements of stockholders' equity and of cash flows for the six-month periods ended June 30, 2001 and 2000. These financial statements are the responsibility of the Corporation's management.

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

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

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of CNA Surety Corporation and subsidiaries as of December 31, 2000, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated February 12, 2001, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2000 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Deloitte & Touche LLP
Chicago, Illinois
July 30, 2001

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

	(Unaudite June 3 2001
ASSETS	
Invested assets and cash:	
Fixed income securities, at fair value (amortized cost: $448,556 and $453,570)	$ 454,6
Equity securities, at fair value (cost: $41,703 and $37,761)	36,6
Short-term investments, at cost (approximates fair value)	43,2
Other investments, at fair value	5,1
Cash	6,4
Total invested assets and cash	546,1
Deferred policy acquisition costs	95,3
Insurance receivables:	
Premiums, including $34,694 and $31,607 from affiliates	45,5
Reinsurance, including $12,858 and $13,349 from affiliates	84,6

Intangible assets (net of accumulated amortization: $22,474 and $19,426)	146,8
Property and equipment, at cost (less accumulated depreciation: $14,810 and $13,677)	15,2
Prepaid reinsurance premiums	4,9
Receivables for securities sold	
Other assets	7,8
Total assets	$ 946,6

LIABILITIES	
Reserves:	
Unpaid losses and loss adjustment expenses	$ 206,5
Unearned premiums	202,4
Total reserves	408,9
Debt	76,5
Deferred income taxes, net	21,9
Payable for securities purchased	4,3
Current income taxes payable	4,6
Reinsurance and other payables to affiliates	7,2
Other liabilities	34,4
Total liabilities	$ 558,1
Commitments and contingencies (Note 4)	
STOCKHOLDERS' EQUITY	
Preferred stock, par value $.01 per share, 20,000 shares authorized; none issued and outstanding	
Common stock, par value $.01 per share, 100,000 shares authorized; 44,194 shares issued and 42,751 shares outstanding at June 30, 2001 and 44,146 shares issued and 42,702 shares outstanding at December 31, 2000	4
Additional paid-in capital	253,8
Retained earnings	149,3
Accumulated other comprehensive income	4
Treasury stock, at cost	(15,4
Total stockholders' equity	388,5
Total liabilities and stockholders' equity	$ 946,6

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

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

Three Months Ended Six

	June 30,		
	2001	2000	2001
Revenues:			
Net earned premiums	$ 78,850	$ 75,554	$155,5
Net investment income	7,480	7,267	15,2
Net realized investment gains	192	234	1
	86,522	83,055	170,9
Expenses:			
Net losses and loss adjustment expenses	16,813	13,688	32,8
Net commissions, brokerage and other underwriting	48,184	44,025	95,0
Interest expense	957	1,729	2,5
Non-recurring charge	--	500	
Amortization of intangible assets	1,524	1,523	3,0
	67,478	61,465	133,5
Income before income taxes	19,044	21,590	37,4
Income taxes	6,701	7,483	13,1
Net income	$ 12,343	$ 14,107	$ 24,2
Earnings per share	$ 0.29	$ 0.33	$ 0.
Earnings per share, assuming dilution	$ 0.29	$ 0.33	$ 0.
Weighted average shares outstanding	42,738	42,898	42,7
Weighted average shares outstanding, assuming dilution	42,931	43,080	42,9

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

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

	Common Stock Shares Outstanding	Common Stock	Additional Paid-In Capital	Comprehensive Income	Retained Earnings	Accu O Comp Inco

Balance, December 31, 1999	43,006	$ 441	$ 253,366		$ 95,419	$
Comprehensive income:						
Net income	--	--	--	$ 28,220	28,220	
Other comprehensive income:						
Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of $375	--	--	--	1,837	--	
Total comprehensive income				$ 30,057		
Purchase of treasury stock	(110)	--	--		--	
Stock options exercised and other ...	3	--	23		--	
Dividends paid to stockholders	--	--	--		(6,863)	
Balance, June 30, 2000	42,899	$ 441	$ 253,389		$ 116,776	$
Balance, December 31, 2000	42,702	$ 441	$ 253,497		$ 135,308	$
Comprehensive income:						
Net income	--	--	--	$ 24,287	24,287	
Other comprehensive income:						
Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of $152.................	--	--	--	156	--	
Total comprehensive income				$ 24,443		
Purchase of treasury stock	--	--	--		--	
Stock options exercised and other ...	49	1	328		--	
Dividends paid to stockholders	--	--	--		(10,257)	
Balance, June 30, 2001	42,751	$ 442	$ 253,825		$ 149,338	$

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

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

	Si
	200
OPERATING ACTIVITIES:	
Net income	$ 24,
Adjustments to reconcile net income to net cash provided by operating activities:	

Depreciation and amortization	4,
Accretion of bond discount, net	
Net realized investment losses	(
Changes in:	
Insurance receivables	(13,
Reserve for unearned premiums	
Reserve for unpaid losses and loss adjustment expenses	2,
Deferred policy acquisition costs	(3,
Deferred income taxes, net	2,
Reinsurance and other payables to affiliates	(
Other assets and liabilities, net	(2,
Net cash provided by operating activities	12,
INVESTING ACTIVITIES:	
Fixed income securities:	
Purchases	(72,
Maturities	43,
Sales	33,
Purchases of equity securities	(4,
Proceeds from the sale of equity securities	
Changes in short-term investments	9,
Purchases of property and equipment	(1,
Changes in receivables/payables for securities sold/purchased, net	14,
Other, net	
Net cash provided by (used in) investing activities	23,
FINANCING ACTIVITIES:	
Principal payments on long-term debt	(25,
Dividends to stockholders	(10,
Purchase of treasury stock	
Other	
Net cash used in financing activities	(35,
Increase in cash	
Cash at beginning of period	5,
Cash at end of period	$ 6,
Supplemental Disclosure of Cash Flow Information:	
Cash paid during the period for:	
Interest	$ 2,
Income taxes	$ 12,

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, 2001
(UNAUDITED)

1. SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

Estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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 2000 Annual Report to Shareholders. Certain financial information that is normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America, is not required for interim reporting and has been condensed or omitted. The accompanying unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all adjustments necessary for a fair presentation of the interim financial statements. All such adjustments are of a normal and recurring nature. The financial results for interim periods may not be indicative of financial results for a full year. Certain reclassifications have been made to the 2000 Financial Statements to conform with the presentation in the 2001 Condensed Consolidated Financial Statements.

Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 133 entitled "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"). SFAS No. 133 was subsequently amended by SFAS No. 137, which delayed the effective date by one year, and SFAS No. 138, which clarified four areas which were causing difficulties in implementation. SFAS No. 133 requires the recognition of all derivative financial instruments, including embedded derivative instruments, as either assets or liabilities in the statement of financial position and measurement of those instruments at fair value. The accounting for gains and losses associated with changes in the fair value of a derivative and the effect on the consolidated financial statements will depend on its hedge designation and whether the hedge is highly effective in achieving offsetting changes in the fair value or cash flows of the asset or liability hedged. If the derivative is designated in a fair value hedge, the changes in the fair value of the derivative and the hedged item will be recognized in earnings. If the derivative is designated as a cash flow hedge, changes in the fair value of the derivative will be recorded in other comprehensive income and will be recognized in the income statement when the hedged item affects earnings. A derivative that does not qualify as a hedge will be marked to fair value through earnings. The transition adjustments resulting from adoption must be reported in net income or other comprehensive income, as appropriate, as the cumulative effect of a change in accounting principle. The Company has adopted this standard effective January 1, 2001, such adoption did not have an impact on the Company's financial position or results of operations.

In March of 1998, the National Association of Insurance Commissioners adopted the Codification of Statutory Accounting Principles ("Codification"). Codification, which intends to standardize regulatory accounting and reporting to state insurance departments, became effective on January 1, 2001. However, statutory accounting principles will continue to be established by individual state laws and permitted practices. The states in which CNA Surety's insurance subsidiaries conduct business required adoption of Codification for the preparation of statutory financial statements effective January 1, 2001. The adoption of Codification increased the Company's statutory capital and surplus as of January 1, 2001 by approximately $21.9 million.

On April 1, 2001, the Company adopted Emerging Issues Task Force ("EITF") Issue No. 99-20, RECOGNITION OF INTEREST INCOME AND IMPAIRMENT ON PURCHASED AND RETAINED BENEFICIAL INTERESTS IN SECURITIZED FINANCIAL ASSETS ("EITF 99-20"). EITF 99-20 establishes how a transferor that retains an interest in securitized financial assets or an enterprise that purchases a beneficial interest in securitized financial assets or an enterprise that purchases a beneficial interest in securitized financial assets should account for interest income and impairment. This issue did not have a significant impact on the results of operations or equity of the Company.

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 141 and No. 142 entitled "Business Combinations" ("SFAS No. 141") and "Goodwill and Other Intangible Assets" ("SFAS No. 142"), respectively. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations subsequent to June 30, 2001 and specifies criteria for recognizing intangible assets acquired in a business combination. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually. Any impairment loss for the excess of the carrying amount of an intangible asset over its fair value would be recognized as a charge to operations. Intangible assets with definite useful lives will continue to be amortized over their respective estimated useful lives. The Company plans to adopt the provisions of Statement No. 142 effective January 1, 2002. The Company has not completed a full analysis of the impact of SFAS No. 142, but anticipates the adoption of SFAS No. 142 will have a favorable impact on the Company's reported net income as amortization of goodwill, currently $5.1 million annually, will cease. The Company will have to review its accounting for intangible assets and the related $1.0 million in annual amortization expense under SFAS No. 142.

2. INVESTMENTS

The estimated amortized cost and fair value of fixed income securities held by CNA Surety at June 30, 2001 and December 31, 2000, by investment category, were as follows (dollars in thousands):

June 30, 2001	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses
Fixed income securities:			
U.S. Treasury securities and obligations of U.S. Government and agencies:			

U.S. Treasury	$ 15,206	$ 234	$ (82)
U.S. Agencies	55,567	1,379	(685)
Collateralized mortgage obligations	652	3	(3)
Mortgage pass-through securities	34,856	256	(214)
Obligations of states and political subdivisions	199,330	5,512	(607)
Corporate bonds	82,291	1,008	(1,529)
Non-agency collateralized mortgage obligations	7,293	125	(41)
Other asset-backed securities:			
Second mortgages/home equity loans	16,918	272	0
Credit card receivables	10,426	178	(104)
Manufactured housing	7,540	235	(70)
Other	1,032	73	(1)
Redeemable preferred stock	17,445	196	(24)
Total fixed income securities	448,556	9,471	(3,360)
Equity securities	41,703	3,054	(8,063)
Total	$490,259	$ 12,525	$(11,423)

December 31, 2000	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses
Fixed income securities:			
U.S. Treasury securities and obligations of U.S. Government and agencies:			
U.S. Treasury	$ 19,727	$ 279	$ (8)
U.S. Agencies	52,760	1,835	(212)
Collateralized mortgage obligations	1,098	1	(9)
Mortgage pass-through securities	42,054	149	(189)
Obligations of states and political subdivisions	208,423	5,136	(929)
Corporate bonds	62,055	675	(2,011)
Non-agency collateralized mortgage obligations	12,319	70	(132)
Other asset-backed securities:			
Second mortgages/home equity loans	18,043	160	(210)
Credit card receivables	10,490	106	(5)
Manufactured housing	12,967	143	(235)
Other	1,272	69	(3)
Redeemable preferred stock	12,362	89	(55)
Total fixed income securities	453,570	8,712	(3,998)
Equity securities	37,761	3,562	(7,396)
Total	$491,331	$ 12,274	$(11,394)

3. REINSURANCE

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

	Six Months Ended Ju		
	2001		
	Written	Earned	Wr
Direct	$ 64,156	$ 57,006	$
Assumed from affiliates	97,110	104,086	
Ceded	(7,815)	(5,493)	
	$ 153,451	$ 155,599	$

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

	S
	200
Gross losses and loss adjustment expenses	$ 5
Ceded amounts	(1
Net losses and loss adjustment expenses	$ 3

4. COMMITMENTS AND CONTINGENCIES

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

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CNA SURETY CORPORATION AND SUBSIDIARIES

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

GENERAL

The following is a discussion and analysis of CNA Surety Corporation ("CNA Surety" or the "Company") and its insurance subsidiaries' operating results, liquidity and capital resources, and financial condition. This discussion should be read in conjunction with the Condensed Consolidated Financial Statements of CNA Surety and notes thereto.

FORMATION OF CNA SURETY AND MERGER

In December 1996, CNA Financial Corporation ("CNAF") and Capsure Holdings Corp. ("Capsure") agreed to merge (the "Merger") the surety business of CNAF with Capsure's insurance subsidiaries, Western Surety Company ("Western Surety") and Universal Surety of America ("USA"), into CNA Surety Corporation ("CNA Surety" or the "Company"). CNAF, through its operating subsidiaries, writes multiple lines of property and casualty insurance, including surety business that is reinsured by Western Surety. CNAF owns approximately 64% of the outstanding common stock of CNA Surety. Loews Corporation owns approximately 87% of the outstanding common stock of CNAF. The principal operating subsidiaries of CNAF that wrote the surety line of business for their own account prior to the Merger were Continental Casualty Company and its property and casualty affiliates (collectively, "CCC") and The Continental Insurance Company and its property and casualty affiliates (collectively, "CIC"). CIC was acquired by CNAF on May 10, 1995.

Pursuant to a reorganization agreement, CCC Surety Operations and Capsure merged their respective operations at the close of business on September 30, 1997 ("Merger Date"). CNAF, through its property and casualty subsidiaries, CCC and CIC, contributed $52.25 million of capital to CNA Surety. Through reinsurance agreements, CCC and CIC ceded to Western Surety all of their net unearned premiums and loss and loss adjustment expense reserves, as of the Merger Date, and will cede to Western Surety all surety business written or renewed by CCC and CIC for a period of five years thereafter. Further, CCC and CIC have agreed to assume the obligation for any adverse development on recorded reserves for CCC Surety Operations as of the Merger Date, to limit the loss ratio on certain defined business written by CNA Surety through December 31, 2000 and to provide certain additional excess of loss reinsurance.

BUSINESS

CNA Surety's insurance subsidiaries write surety and fidelity bonds in all 50 states through a combined network of approximately 37,000 independent agencies. CNA Surety's principal insurance subsidiaries are Western Surety and USA. The insurance subsidiaries write, on a direct basis or as business assumed from CCC and CIC, small fidelity and non-contract surety bonds, referred to as commercial bonds; small, medium and large contract bonds; international surety and credit insurance; and errors and omissions ("E&O") liability insurance. Western Surety is a licensed insurer in all 50 states and the District of Columbia. USA is licensed in 44 states and the District of Columbia. Western Surety's affiliated company, Surety Bonding Company of America ("SBCA"), is licensed in 25 states and the District of Columbia.

"SAFE HARBOR" STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

The statements which are not historical facts contained in this Form 10-Q are forward-looking statements that involve risks and uncertainties, including, but not limited to, product and policy demand and market response risks, the effect of economic conditions, the impact of competitive products, policies and pricing, product and policy development, regulatory changes and conditions, rating agency policies and practices, development of claims and the effect on loss reserves, the performance of reinsurance companies under reinsurance contracts with the Company, investment portfolio developments and reaction to market conditions, the results of financing efforts, the actual closing of contemplated transactions and agreements, the effect of the Company's accounting policies, and other risks detailed in the Company's Securities and Exchange

Commission filings. No assurance can be given that the actual results of operations and financial condition will conform to the forward-looking statements contained herein.

RESULTS OF OPERATIONS

CNA SURETY RESULTS FOR THREE- AND SIX- MONTHS ENDED JUNE 30, 2001 AND 2000

The components of net income for the Company for the three and six months ended June 30, 2001 and 2000 are summarized as follows (dollars in thousands, except per share amounts):

	Three Months Ended June 30,	
	2001	2000
Total revenues	$ 86,522	$ 83,055
Underwriting income	$ 13,853	$ 17,841
Net investment income	7,480	7,267
Net realized investment gains	192	234
Interest expense	957	1,729
Non-recurring charge	--	500
Amortization of intangible assets	1,524	1,523
Income before income taxes	19,044	21,590
Income taxes	6,701	7,483
Net income	$ 12,343	$ 14,107
Net income per share	$ 0.29	$ 0.33

Insurance Underwriting

Underwriting results for the Company for the three and six months ended June 30, 2001 and 2000 are summarized in the following table (dollars in thousands):

	Three Months Ended June 30,	
	2001	2000
Gross written premiums	$ 85,782	$ 82,376
Net written premiums	$ 80,824	$ 78,410

Net earned premiums..........................	$ 78,850	$ 75,554	$
Net losses and loss adjustment expenses.......	16,813	13,688	
Net commissions, brokerage and other..........	48,184	44,025	
Underwriting income..........................	$ 13,853	$ 17,841	$
Loss ratio..................................	21.3%	18.1%	
Expense ratio...............................	61.1	58.3	
Combined ratio..............................	82.4%	76.4%	

Premiums Written

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

Effective January 1, 2001, the Company began delaying the recording of written premium until the effective date of the bond, rather than recording on the date the bond is processed ("processed premium"). The change did not impact the recognition of net earned premium but did impact gross written premiums.

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

	Three Months Ended June 30,		
	2001	2000	
Contract....................................	$ 48,012	$ 42,152	$
Commercial..................................	31,432	33,739	
Fidelity and other..........................	6,338	6,485	
	$ 85,782	$ 82,376	$

Gross written premiums increased 4.1% to $85.8 million, for the three months ended June 30, 2001 over the comparable period in 2000. The impact of the change in the timing of recording written premiums for the three months ended June 30, 2001, as compared to 2000, was insignificant. Excluding the discontinuance of the CNA Reinsurance Company, Limited (London) ("CNA Re") assumed international credit and surety business, core direct gross written premiums increased 8.1%. Contract surety accounted for the majority of this increase with growth of 13.9% to $48.0 million in gross written premiums as compared to 2000. This increase is primarily attributable to continued strength in public construction nationwide particularly highway and road, airport and school related projects. Gross written premiums for core direct commercial surety (excluding international reinsurance business assumed from CNA Re) increased 2.3% to $31.4 million, for the three months ended June 30, 2001 reflecting increased business with key distribution partners. Fidelity and

other products decreased 2.3% to $6.3 million for the three months ended June 30, 2001 as compared to the same period in 2000.

Gross written premiums decreased 1.1% to $161.3 million for the six months ended June 30, 2001 over the comparable period in 2000. Six month gross written premium reflects a decrease associated with the change in the timing of recording written premiums of $10.2 million and the discontinuance of the CNA Re assumed international credit and surety business of $6.0 million. Excluding international reinsurance business assumed from CNA Re, core direct gross processed premiums increased 9.2% to $171.5 million with contract surety and commercial surety up 10.2% and 8.2%, respectively. These increases were primarily due to continued strength in public construction spending for contract surety and reflect increased commercial business with key distribution partners and positive fluctuations in large commercial account activity.

Gross written premiums for contract surety increased 8.5% to $86.3 million, for the six months ended June 30, 2001. Gross written premiums for core direct commercial surety (excluding international reinsurance business assumed from CNA Re) decreased 4.8% to $60.4 million. Fidelity and other products increased 3.7% to $14.5 million for the six months ended June 30, 2001 as compared to the same period in 2000.

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

	Three Months Ended June 30,		
	2001	2000	
Contract....................................	$ 43,512	$ 38,546	$
Commercial..................................	30,974	33,354	
Fidelity and other..........................	6,338	6,510	
	$ 80,824	$ 78,410	$

For the three months ended June 30, 2001, net written premiums increased 3.1% to $80.8 million as compared to the same period in 2000, reflecting the aforementioned gross production changes partially offset by higher reinsurance costs. The reinsurance costs reflected in ceded premiums are based upon reinsurers' loss experience under the Company's surety excess of loss reinsurance contract. Due primarily to increased large losses reported to the Company's excess of loss reinsurers, ceded written premiums increased $1.2 million to $5.2 million for the three months ended June 30, 2001. Net written premiums for contract surety business increased 12.9% To $43.5 million. Net written premiums for commercial surety, excluding international reinsurance business assumed, increased 2.0% to $31.0 million for the second quarter in 2001. The fidelity and other products decreased 2.6% to $6.3 million, for the second quarter in 2001 as compared to the same period in 2000.

For the first half of 2001, net written premiums decreased 2.6% to $153.5 million, over the comparable period in 2000 with contract surety up 6.4% and core commercial surety down 4.8%. The fidelity and other book of business increased 0.4% to $14.5 million, for the six months ended june 30, 2001 as compared to the same period in 2000.

Since the second half of calendar year 1999, the Company has experienced an increase in claim severity in the most recent accident years, primarily with respect to large commercial risks. As a result of this

increase in large loss activity where the Company cedes loss amounts in excess of $5 million per principal under its excess of loss reinsurance program, CNA Surety is paying higher costs for reinsurance. Given the current economic weakness, the Company's reinsurance costs are unlikely to return to historical levels in 2001. The higher reinsurance costs will have an adverse impact on the Company's future results of operations.

Underwriting Income

Underwriting income decreased 22.4% to $13.9 million for the three months ended June 30, 2001 compared to $17.8 million for the same period in 2000. This decrease is primarily due to higher incurred losses. Increased claim severity, primarily in large commercial risks, has reduced underwriting profits by increasing the estimates of incurred losses for more recent accident years. The period to period changes in underwriting income reflect a 22.8% increase in net losses and loss adjustment expenses. Underwriting income decreased 21.3% to $27.7 million for the six months ended June 30, 2001 compared to the same period in 2000. The six month period to period change in underwriting income reflects a 20.7% increase in net losses and loss adjustment expenses.

Loss Ratio

The loss ratios for the three months ended June 30, 2001 and 2000 were 21.3% and 18.1%, respectively. The loss ratios included $0.1 million of net unfavorable loss reserve development and $1.8 million of net favorable loss reserve development for the three months ended June 30, 2001 and 2000, respectively. Excluding the impact of loss reserve development, the loss ratios would have been 21.2% and 20.5% for the period ended June 30, 2001 and June 30, 2000, respectively. The surety business assumed from CCC and CIC is subject to an aggregate stop loss reinsurance contract between CCC and the Company that limits the Company's accident year net loss ratio on this business to 24% for accident years 1997 (October 1, 1997 to December 31, 1997), 1998, 1999 and 2000. For the six months ended June 30, 2001 and 2000, the loss ratios were 21.1% and 18.0%, respectively. The loss ratios included $0.2 million and $3.9 million of net favorable reserve development for the six months ended June 30, 2001 and 2000, respectively. Excluding the impact of the favorable reserve development, the loss ratios would have been 21.2% and 20.6% for the six month periods ended June 30, 2001 and June 30, 2000, respectively. The increases in the adjusted loss ratio for the three and six month periods in 2001 relate primarily to higher incurred losses and changes in business mix.

Expense Ratio

The expense ratio increased to 61.1% for the three months ended June 30, 2001 compared to 58.3% for the same period in 2000. For the six months ended June 30, 2001, the expense ratio increased to 61.1% from 58.8% for the same period in 2000. The increase in the expense ratio for the three- and six- months ended June 30, 2001 primarily reflects higher operating costs, primarily technology related expenditures, and the impact of higher reinsurance costs on net earned premiums. For the first half of 2001, net earned premiums increased 2.9% and operating expenses increased at a higher rate of 7.0%, primarily associated with increased technology related expenditures.

Investment Income

For the three months ended June 30, 2001, net investment income was $7.5 million compared to net investment income for the three months ended June 30, 2000 of $7.3 million. The increase in investment income primarily reflects higher average invested assets. The annualized pretax yields for the Company's

equity and fixed income portfolio were 5.5% and 5.4% for the three months ended June 30, 2001 and 2000, respectively. The annualized after-tax yields for the Company's equity and fixed income portfolio were 4.0% and 4.1% for the three months ended June 30, 2001 and 2000, respectively. Net investment income for the six months ended June 30, 2001 and 2000 was $15.2 million and $14.5 million, respectively. The average pretax yields were 5.6% for the six months ended June 30, 2001 and 2000. The annualized after-tax yields for the Company's equity and fixed income portfolio were 4.1% and 4.2% for the six months ended June 30, 2001 and 2000, respectively.

Net realized investment gains were approximately $0.2 million for the three and six months ended June 30, 2001 and 2000.

Analysis of Other Operations

Amortization expense was $1.5 million for the three months ended June 30, 2001 and 2000. For the six months ended June 30, 2001 and 2000, amortization of intangibles was $3.0 million. Intangible assets primarily represent goodwill and identified intangibles arising from the acquisition of Capsure. Intangible assets are generally amortized over 30 years.

Interest expense decreased 44.7% for the second quarter of 2001 as compared to the same period in 2000, primarily due to lower outstanding debt levels and lower interest rates. Average debt outstanding was $78.0 million for the second quarter in 2001 compared to $101.9 million in the second quarter of 2000. The weighted average interest rate for the three months ended June 30, 2001 was 4.7% compared to 6.5% for the same period in 2000. Interest expense decreased 24.0% for the first six months of 2001 as compared to the same period in 2000. Average debt outstanding was $89.4 million for the first six months in 2000 compared to $101.9 million in the first six months of 2000. The weighted average interest rate for the six months ended June 30, 2001 was 5.4% compared to 6.4% for the same period in 2000.

Income Taxes

Income tax expense was $6.7 million and $7.5 million and the effective income tax rates were 35.2% and 34.7% for the three months ended June 30, 2001 and 2000, respectively. For the six months ended June 30, 2001 and 2000, income tax expense was $13.2 million and $14.7 million and the effective income tax rates were 35.2% and 34.3%, respectively. The increases in the estimated effective tax rate in 2001 primarily relates to anticipated decreases in tax exempt investment income.

LIQUIDITY AND CAPITAL RESOURCES

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

On May 16, 2001, the CNA Surety Board of Directors increased the quarterly dividend from $0.09 to $0.15 per share beginning with the quarterly dividend payable on July 5, 2001.

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, 2001, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of $449.7 million of fixed income securities, $36.7 million of equity securities, $12.0 million of short-term investments, $5.1 million of other investments and $4.4 million of cash. At December 31, 2000, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of $453.2 million of fixed income securities, $33.9 million of equity securities, $8.7 million of short-term investments, $5.1 million of other investments and $4.0 million of cash.

Cash flow at the parent company level is derived principally from dividend and tax sharing payments from its insurance subsidiaries. The principal obligations at the parent company level are to service debt, pay operating expenses, including income taxes, and pay dividends to stockholders. At June 30, 2001, the parent company's invested assets consisted of $5.0 million of fixed income securities and $31.3 million of short-term investments and $2.0 million of cash. At December 31, 2000, the parent company's invested assets consisted of $5.1 million of fixed income securities, $44.0 million of short-term investments and $2.0 million of cash.

The Company's consolidated net cash flow provided by operating activities was $12.4 million for the six months ended June 30, 2001 and $38.6 million for the comparable period in 2000. The decrease in net cash flow provided by operating activities primarily relates to increases in insurance receivables, primarily reinsurance recoverables, and higher net loss payments in the current period.

CNA Surety's bank borrowings are under a five-year unsecured revolving credit facility (the "Credit Facility") that provides for borrowings of up to $130 million. As of June 30, 2001, the Company has unused capacity under the revolver of approximately $55 million.

The interest rate on borrowings under the Credit Facility may be fixed, at CNA Surety's option, for a period of one, two, three, or six months and is based on, among other rates, the London Interbank Offered Rate ("LIBOR"), plus the applicable margin. The margin, including the facility fee, was 0.30% at June 30, 2001 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 0.25% to 0.40%. As of June 30, 2001, the weighted average interest rate was 4.0% on the $75.0 million of outstanding borrowings. As of December 31, 2000, the weighted average interest rate was 6.9% on the $100.0 million of outstanding borrowings.

The Credit Facility contains, among other conditions, limitations on CNA Surety with respect to the incurrence of additional indebtedness and requires the maintenance of certain financial ratios. As of June 30, 2001, the Company was in compliance with all restrictions and covenants contained in the Credit Facility agreement. The Credit Facility provides for the payment of all outstanding principal balances by September 30, 2002 with no required principal payments prior to such time. Principal prepayments, if any, and interest payments are expected to be funded primarily through dividends from CNA Surety's insurance subsidiaries.

In 1999 CNA Surety acquired certain assets of Clark Bonding Company, Inc., a Charlotte, North Carolina, insurance agency and brokerage doing business as The Bond Exchange for $5.9 million. As part of this acquisition, the Company incurred an additional $1.9 million of debt in the form of a promissory note. The promissory note matures on July 27, 2004 and has an interest rate of 5.0%. The balance of this promissory note at June 30, 2001 was $1.6 million.

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

The dividends that may be paid without prior regulatory approval are determined by formulas established by the applicable insurance regulations, as described above. The formulas that determine dividend capacity in the current year are dependent on, among other items, the prior year's ending statutory surplus and statutory net income. Dividend capacity for 2001 is based on statutory surplus and income at and for the year ended December 31, 2000. Without prior regulatory approval in 2001, CNA Surety's insurance subsidiaries may pay stockholder dividends of $60.2 million in the aggregate. CNA Surety received $35.0 million in dividends from its insurance subsidiaries during the first six months of 2001 and $20.0 million in the first six months of 2000.

In accordance with the provisions of intercompany tax sharing agreements between CNA Surety and its subsidiaries, the tax of each subsidiary shall be determined based upon each subsidiary's separate return liability. Intercompany tax payments are made at such times as estimated tax payments would be required by the Internal Revenue Service ("IRS"). CNA Surety received tax sharing payments from its subsidiaries of $12.2 million for the six months ended June 30, 2001 and $15.2 million for the same period in 2000.

CNA Surety management believes that it will have sufficient available resources to meet its present capital needs.

IMPACT OF ACCOUNTING PRONOUNCEMENTS NOT YET ADOPTED

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 141 and No. 142 entitled "Business Combinations" ("SFAS No. 141") and "Goodwill and Other Intangible Assets" ("SFAS No. 142"), respectively. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations subsequent to June 30, 2001 and specifies criteria for recognizing intangible assets acquired in a business combination. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually. Any impairment loss for the excess of the carrying amount of an intangible asset over its fair value would be recognized as a charge to operations. Intangible assets with definite useful lives will continue to be amortized over their respective estimated useful lives. The Company plans to adopt the provisions of Statement No. 142 effective January 1, 2002. The Company has not completed a full analysis of the impact of SFAS No. 142, but anticipates the adoption of SFAS No. 142 will have a favorable impact on the Company's reported net income as amortization of goodwill, currently $5.1 million annually, will cease. The Company will have to review its accounting for intangible assets and the related $1.0 million in annual amortization expense under SFAS No. 142.

CNA SURETY CORPORATION AND SUBSIDIARIES

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings - None.

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

ITEM 3. Defaults Upon Senior Securities - None.

ITEM 4. Submission of Matters to a Vote of Security Holders -

At the Annual Meeting of Shareholders of CNA Surety Corporation held on May 15, 2001, the Company's shareholders voted on the following proposals. The number of shares issued, outstanding and eligible to vote as of the record date of March 19, 2001 were 42,724,558. Proxies representing 40,890,003 shares or 96 percent of the eligible voting shares were tabulated.

PROPOSAL I
Election of Directors.

	Number of Shares/Votes	
	For	Authority Withheld

Giorgio Balzer	40,496,888	393,115
Philip H. Britt	40,751,588	138,415
Edward Dunlop	40,496,888	393,115
Melvin Gray	40,496,888	393,015
Joe P. Kirby	40,492,268	397,735
Roy E. Posner	40,745,488	144,515
Thomas F. Taylor	40,491,663	398,340
Adrian M. Tocklin	40,745,633	144,370
Mark C. Vonnahme	39,532,290	1,357,713

PROPOSAL II
To ratify the Board of Directors' appointment of the Company's independent auditors, Deloitte & Touche LLP for fiscal year 2001.

For	40,814,240
Against	71,507
Abstain	4,256

CNA SURETY CORPORATION AND SUBSIDIARIES

PART II - OTHER INFORMATION (continued)

ITEM 5. Other Information - None.

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

(a) Exhibits: - None.

(b) Reports on Form 8-K:
May 11, 2001; CNA Surety Corporation Press Release issued on April 30, 2001.
May 16, 2001; CNA Surety Corporation Press Release issued on May 16, 2001.

SIGNATURES

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

CNA SURETY CORPORATION
(Registrant)

/s/ John S. Heneghan

John S. Heneghan
Vice President and Chief Financial Officer

Date: August 13, 2001