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CNA SURETY CORP  
Form 10-Q/A  
March 15, 2004

FORM 10-Q/A

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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

For the quarterly period ended SEPTEMBER 30, 2003

OR

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

Commission file number: 1-13277

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

DELAWARE 36-4144905  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

CNA PLAZA, CHICAGO, ILLINOIS 60685  
(Address of principal executive offices) (Zip Code)

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

42,978,052 shares of Common Stock, \$.01 par value as of November 4, 2003.

EXPLANATORY NOTE

This Amendment No. 1 on Form 10-Q/A amends the CNA Surety Corporation ("CNA Surety" or the "Company") Form 10-Q for the period ended September 30, 2003 as filed by the Company on November 13, 2003 and is being filed to amend and restate Item 1 (Financial Statements), Item 2 (Management's Discussion and Analysis of Financial Condition and Results of Operations), Item 4 (Controls and Procedures) and Item 6 (Exhibits and Reports on Form 8-K). Subsequent to the filing of CNA Surety's Report on Form 10-Q for the fiscal quarter ended September 30, 2003, the Company revised its accounting for ceded premiums under

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a multiple year excess of loss reinsurance treaty with its affiliate, Continental Casualty Company ("CCC"), which has been in place since October 1, 2002. Under the contract CNA Surety pays a quarterly premium of \$3.125 million, of which 70% is added to an experience account that is reduced by any losses ceded to the treaty. To the extent CNA Surety commutes the treaty, it is entitled to receive payment from CCC of its experience account balance. Under Emerging Issues Task Force ("EITF") Issue 93-6 "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises" ("EITF 93-6"), a receivable for return premium based on experience under the contract should be established at September 30, 2003. CNA Surety had not previously established such a receivable, and has restated its 2003 condensed consolidated financial statements to comply with EITF 93-6.

This report on Form 10-Q/A does not reflect the effect of any events subsequent to the filing of the original Form 10-Q, except the aforementioned restatement.

CNA SURETY CORPORATION AND SUBSIDIARIES

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## ITEM 1. FINANCIAL STATEMENTS

### INDEPENDENT ACCOUNTANTS' REPORT

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

We have reviewed the accompanying condensed consolidated balance sheet of CNA Surety Corporation and subsidiaries as of September 30, 2003, and the related condensed consolidated statements of income, stockholders' equity and cash flows for the three and nine month periods ended September 30, 2003 and 2002. These interim financial statements are the responsibility of the Corporation's management.

We conducted our reviews 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 and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of CNA Surety Corporation and subsidiaries as of December 31, 2002, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated February 10, 2003, March 12, 2004, as to Note 17, we expressed an unqualified opinion on those consolidated financial statements (which report included explanatory paragraphs relating to the change in accounting for goodwill and indefinite-lived intangible assets in 2002 and the restatement described in Note 17). In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2002 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

As discussed in Note 7 to the condensed consolidated financial statements, the accompanying 2003 condensed consolidated financial statements have been restated.

Deloitte & Touche LLP  
Chicago, Illinois  
November 3, 2003

(March 12, 2004 as to the effects of the restatement described in Note 7.)

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	September 30, 2003
	----- As restated (a)
<b>ASSETS</b>	
Invested assets and cash:	
Fixed income securities, at fair value (amortized cost: \$521,400 and \$539,364)	\$ 557,339
Equity securities, at fair value (cost: \$914 and \$852)	910
Short-term investments, at cost (approximates fair value)	60,755
Other investments, at fair value	1,117
Cash	10,329
	-----
Total invested assets and cash	630,450
Deferred policy acquisition costs	105,943
Insurance receivables:	
Premiums, including \$14,583 and \$34,097 from affiliates (net of allowance for doubtful accounts: \$1,575 and \$1,365)	32,363
Reinsurance, including \$53,890 and \$17,589 from affiliates	161,948
Intangible assets (net of accumulated amortization: \$25,523 and \$25,523)	138,785
Current income taxes receivable	25,035
Property and equipment, at cost (less accumulated depreciation: \$18,052 and \$16,047)	16,421
Prepaid reinsurance premiums	7,606
Receivable for securities sold	7,121
Other assets	9,270
	-----
Total assets	\$ 1,134,942
	=====
<b>LIABILITIES</b>	
Reserves:	
Unpaid losses and loss adjustment expenses	\$ 384,906
Unearned premiums	229,468
	-----
Total reserves	614,374
Debt	50,418
Deferred income taxes, net	30,568
Current income taxes payable	--
Reinsurance and other payables to affiliates	4,035
Other liabilities	36,016
	-----
Total liabilities	\$ 735,411
	-----
Commitments and contingencies (See Note 6)	
<b>STOCKHOLDERS' EQUITY</b>	
Common stock, par value \$.01 per share, 100,000 shares authorized; 44,398 shares issued and 42,977 shares outstanding at September 30, 2003 and 44,386 shares issued and 42,947 shares outstanding at December 31, 2002	\$ 444
Additional paid-in capital	255,795
Retained earnings	135,190
Accumulated other comprehensive income	23,358
Treasury stock, at cost	(15,256)
	-----
Total stockholders' equity	399,531
	-----
Total liabilities and stockholders' equity	\$ 1,134,942
	=====

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

(a) See Note 7.

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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 September 30,	
	2003	2002
	As restated (a)	
<b>Revenues:</b>		
Net earned premium.....	\$ 77,732	\$ 79,196
Net investment income.....	6,429	7,031
Net realized investment gains (losses).....	1	(698)
	-----	-----
Total revenues.....	84,162	85,529
	-----	-----
<b>Expenses:</b>		
Net losses and loss adjustment expenses.....	112,492	35,380
Net commissions, brokerage and other underwriting expenses	48,805	46,027
Interest expense.....	372	407
	-----	-----
Total expenses.....	161,669	81,814
	-----	-----
Income (loss) before income taxes.....	(77,507)	3,715
Income tax expense (benefit).....	(30,088)	1,098
	-----	-----
Net income (loss).....	\$ (47,419)	\$ 2,617
	=====	=====
Earnings per share.....	\$ (1.10)	\$ 0.06
	=====	=====
Earnings per share, assuming dilution.....	\$ (1.10)	\$ 0.06
	=====	=====
Weighted average shares outstanding.....	42,971	42,945
	=====	=====
Weighted average shares outstanding, assuming dilution.....	42,994	43,094
	=====	=====

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

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(a) See Note 7.

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

	Common Stock Shares Outstanding -----	Common Stock -----
Balance, December 31, 2001 .....	42,780	\$ 442
Comprehensive income:		
Net income .....	--	--
Other comprehensive income:		
Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of \$1,190 .....	--	--
Total comprehensive income .....		
Issuance of treasury stock to employee stock purchase program .....	10	
Stock options exercised and other .....	157	2
Dividends paid to stockholders .....	--	--
	-----	-----
Balance, September 30, 2002 .....	42,947	\$ 444
	=====	=====
Balance, December 31, 2002 (As restated (a)) .....	42,947	\$ 444
Comprehensive income:		
Net income (loss) (As restated (a)) .....	--	--
Other comprehensive income:		
Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of \$(1,846) .....	--	--
Total comprehensive income (loss) (As restated (a)) .....		
Issuance of treasury stock to employee stock purchase program .....	18	--
Stock options exercised and other .....	12	--
	-----	-----
Balance, September 30, 2003 (As restated (a)) .....	42,977	\$ 444
	=====	=====
	Retained Earnings -----	Accumulated Other Comprehensive Income -----
Balance, December 31, 2001 .....	\$ 149,128	\$ 278

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Comprehensive income:		
Net income .....	26,076	--
Other comprehensive income:		
Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of \$1,190 .....	--	17,148
Total comprehensive income .....		
Issuance of treasury stock to employee stock purchase program .....		
Stock options exercised and other .....	--	--
Dividends paid to stockholders .....	(19,309)	--
	-----	-----
Balance, September 30, 2002 .....	\$ 155,895	\$ 17,426
	=====	=====
Balance, December 31, 2002 (As restated (a)) .....	\$ 159,937	\$ 19,861
Comprehensive income:		
Net income (loss) (As restated (a)) .....	(24,747)	--
Other comprehensive income:		
Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of \$(1,846) .....	--	3,497
Total comprehensive income (loss) (As restated (a)) .....		
Issuance of treasury stock to employee stock purchase program .....		
Stock options exercised and other .....		--
	-----	-----
Balance, September 30, 2003 (As restated (a)) .....	\$ 135,190	\$ 23,358
	=====	=====

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

(a) See Note 7.

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

OPERATING ACTIVITIES:

Net income (loss) .....	
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:	
Depreciation and amortization .....	
Accretion of bond discount, net .....	
Net realized investment gains .....	
Changes in:	
Insurance receivables .....	

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Reserve for unearned premiums .....  
Reserve for unpaid losses and loss adjustment expenses .....  
Deferred policy acquisition costs .....  
Deferred income taxes, net .....  
Reinsurance and other payables to affiliates .....  
Prepaid reinsurance premiums .....  
Current income taxes payable (receivable) .....  
Other assets and liabilities .....

Net cash provided by operating activities .....

INVESTING ACTIVITIES:

Fixed income securities:

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

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

FINANCING ACTIVITIES:

Principal payments on debt .....  
Proceeds from long-term debt .....  
Dividends to stockholders .....  
Employee stock option exercises .....  
Issuance of treasury stock to employee stock purchase plan .....

Net cash used in financing activities .....

Increase (decrease) in cash .....

Cash at beginning of period .....

Cash at end of period .....

Supplemental Disclosure of Cash Flow Information:

Cash paid during the period for:

Interest .....  
Income taxes .....

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

(a) See Note 7.



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

### 1. SIGNIFICANT ACCOUNTING POLICIES

#### Principles of Consolidation

The consolidated financial statements include the accounts of CNA Surety Corporation ("CNA Surety" or the "Company") and all majority-owned subsidiaries.

#### Estimates

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

#### Basis of Presentation

These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Company's 2002 10-K/A. Certain financial information that is included in annual financial statements prepared in accordance with GAAP, is not required for interim reporting and has been condensed or omitted. The accompanying unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all adjustments necessary for a fair presentation of the interim financial statements. All such adjustments are of a normal and recurring nature. The financial results for interim periods may not be indicative of financial results for a full year. Certain reclassifications have been made to the 2002 Financial Statements to conform with the presentation in the 2003 Condensed Consolidated Financial Statements.

#### Earnings (Loss) Per Share

Basic earnings (loss) 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 (loss) per common share is computed based on the weighted average number of shares outstanding plus the dilutive effect of common stock equivalents which is computed using the treasury stock method.

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

	Three months ended September 30,	
	2003	2002
Net income (loss) .....	\$(47,419)	\$ 2,000
Shares:		
Weighted average shares outstanding .....	42,967	42,967
Weighted average shares of options exercised .....	4	4

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Total weighted average shares outstanding .....	42,971	42
Effect of dilutive options .....	23	
Total weighted average shares outstanding, assuming dilution .....	42,994	43
Earnings (loss) per share .....	\$ (1.10)	\$
Earnings (loss) per share, assuming dilution .....	\$ (1.10)	\$

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

### Accounting Changes

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

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

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

FIN No. 46 defines a VIE as one in which a) the equity investment is not

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sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties which is provided through other interests that will absorb some or all of the expected losses of the entity or b) the equity investors lack one or more of the following essential characteristics of a controlling financial interest i) direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights or ii) the obligation to absorb the expected losses of the entity, if they occur or receive residual returns of the entity, if they occur or iii) the right to receive the expected residual returns of the entity if they occur. The primary beneficiary of a VIE is required to consolidate the results of operations of the VIE. Financial statements issued are required to disclose the nature, purpose, activities and size of the VIE and maximum exposure to loss as a result of its involvement with the VIE. The Company has adopted FIN No. 46 effective January 1, 2003. The Company is neither a primary beneficiary of a VIE nor does it have a significant involvement with a VIE.

In December 2002, the FASB issued SFAS No. 148 entitled "Accounting for Stock-Based

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Compensation, Transition and Disclosure" ("SFAS No.148"). SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also amends the disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation", to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company adopted this standard beginning with the 2002 annual financial statements. The Company has not adopted fair value accounting in 2003. The Company applies APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations, in accounting for its plans as allowed for under the provisions of SFAS No. 123. Accordingly, no compensation cost has been recognized for its stock-based incentive plans as the exercise price of the granted options equals the market price at the grant date. Had compensation cost for these plans been determined on the fair value at the grant date for options granted, the Company's pro forma net loss for the nine months ended September 30, 2003 would have been \$24.9 million and the Company's pro forma net income for the same period in 2002 would have been \$26.1 million, respectively. Diluted net loss per share would have been \$0.58 for the nine months ended September 30, 2003 and diluted net income per share would have been \$0.61 for the nine months ended September 30, 2002.

The following table illustrates the effect on net income and earnings per share data if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock based compensation under the Company's stock-based compensation plan.

	Three months ended September 30,	
(in thousands, except per share data)	2003	2002
Net income (loss)	\$ (47,419)	\$ 2,617
Adjustment: Total stock based compensation cost determined under the fair value method, net of tax	59	--

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Pro forma net income (loss)	\$ 47,360	\$ 2,617
	=====	=====
Basic and diluted earnings (loss) per share, as reported	\$ (1.10)	\$ 0.06
	=====	=====
Basic and diluted earnings (loss) per share, pro forma	\$ (1.10)	\$ 0.06
	=====	=====

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

In May of 2003, the FASB issued SFAS No. 150 entitled "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS No. 150"). SFAS No. 150 establishes standards for how an issuer of financial instruments classifies and measures in its statement of financial position certain instruments with characteristics of both liabilities and equity. SFAS No. 150 modifies the accounting and financial statement disclosures of certain financial instruments that, under previous guidance, issuers could account for as equity. SFAS No. 150 affects the issuer's accounting for three types of financial instruments that are required to be accounted for as liabilities.

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

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2. INVESTMENTS

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

September 30, 2003	Amortized Cost or Cost	Gross Unrealized Gains
	-----	-----
Fixed income securities:		

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U.S. Treasury securities and obligations of		
U.S. Government and agencies:		
U.S. Treasury .....	\$ 16,847	\$ 792
U.S. Agencies .....	6,553	218
Collateralized mortgage obligations .....	82	2
Mortgage pass-through securities .....	9,261	448
Obligations of states and political subdivisions .....	378,644	24,799
Corporate bonds .....	70,173	7,267
Non-agency collateralized mortgage obligations .....	8,490	548
Other asset-backed securities:		
Second mortgages/home equity loans .....	7,480	507
Credit card receivables .....	5,000	72
Other .....	5,416	300
Redeemable preferred stock .....	13,454	1,322
	-----	-----
Total fixed income securities .....	521,400	36,275
Equity securities .....	914	--
	-----	-----
Total .....	\$522,314	\$ 36,275
	=====	=====

	Amortized Cost or Cost	Gross Unrealized Gains
	-----	-----
December 31, 2002		
Fixed income securities:		
U.S. Treasury securities and obligations of		
U.S. Government and agencies:		
U.S. Treasury .....	\$ 16,140	\$ 960
U.S. Agencies .....	29,396	537
Collateralized mortgage obligations .....	156	7
Mortgage pass-through securities .....	20,981	1,066
Obligations of states and political subdivisions .....	347,918	20,099
Corporate bonds .....	76,181	6,154
Non-agency collateralized mortgage obligations .....	10,497	477
Other asset-backed securities:		
Second mortgages/home equity loans .....	11,842	614
Credit card receivables .....	5,000	87
Other .....	7,838	653
Redeemable preferred stock .....	13,415	854
	-----	-----
Total fixed income securities .....	539,364	31,508
Equity securities .....	852	--
	-----	-----
Total .....	\$540,216	\$ 31,508
	=====	=====

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

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advantage of market conditions or other investment opportunities or regulatory, credit and tax considerations. These activities will produce realized gains and losses.

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

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

3. REINSURANCE

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

	Three Months E	
	----- 2003 -----	
	Written -----	Earned -----
Direct .....	\$ 52,623	\$ 44,192
Assumed .....	41,599	48,980
Ceded .....	(12,084)	(15,440)
	-----	-----
	\$ 82,138	\$ 77,732
	=====	=====

	Nine Months En	
	----- 2003 -----	
	Written -----	Earned -----
Direct .....	\$ 141,388	\$ 119,707
Assumed .....	141,951	150,385
Ceded .....	(38,570)	(44,308)
	-----	-----
	\$ 244,769	\$ 225,784
	=====	=====

The effect of reinsurance on the Company's provision for loss and loss

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adjustment expenses and the corresponding ratio to earned premium was as follows (dollars in thousands):

	Three Months Ended	
	2003	
	\$	Ratio
Gross losses and loss adjustment expenses .....	\$ 141,577	152.0%
Ceded amounts .....	(29,085)	188.4%
Net losses and loss adjustment expenses .....	\$ 112,492	144.7%

	Nine Months Ended	
	2003	
	\$	Ratio
Gross losses and loss adjustment expenses .....	\$ 213,496	79.0%
Ceded amounts .....	(62,163)	140.3%
Net losses and loss adjustment expenses .....	\$ 151,333	67.0%

Assumed premiums primarily includes all surety business written or renewed, net of reinsurance, by

Continental Casualty Company ("CCC") and The Continental Insurance Company ("CIC"), and their affiliates, that is reinsured by Western Surety Company ("Western Surety") pursuant to intercompany reinsurance and related agreements.

2003 Third Party Reinsurance Compared to 2002 Third Party Reinsurance

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

The contract also includes similar special acceptance provisions for

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larger contract accounts contained in the 2002 Excess of Loss Treaty. In addition to the one large national contract principal and the two commercial principals excluded (based upon class of business in 2002), the Company's reinsurers have also excluded three other contract principals from the 2003 Excess of Loss Treaty for a total of six excluded principals. Of the two commercial principals, one is a domestic electric utility with an estimated bonded exposure of \$53 million and is currently rated B by Standard and Poor's ("S&P"). The bonded exposure will decline over the term of the bond which extends until 2007. The other is a foreign industrial enterprise with an estimated bonded exposure of \$31 million. Management estimates that this enterprise has an equivalent S&P rating of B+. The remaining \$31 million of the bonded exposure is expected to be discharged by June 30, 2004. With respect to the three contract principals other than the large national contractor (described below), two principals have substantially completed asset sales, debt reductions and other reorganization efforts. Each of these four principals continues to perform their contractual obligations underlying the Company's surety bonds.

The third contract principal went into claim in the second quarter of 2003. Although in claim and experiencing financial difficulties, the contractor continued to perform substantially all of its contractual obligations underlying the Company's surety bonds. This contractor recently filed for bankruptcy in late September, 2003. This filing increased the likelihood that the contractor will be unable to perform all of its contractual obligations. Based upon currently available information, management believes its net exposure to loss on this contractor could be up to \$15 million. This loss exposure has been considered in the Company's \$49 million net reserve addition in the third quarter of 2003 for the 2003 accident year.

In December 2002 and January 2003, CNAF provided loans in an aggregate amount of approximately \$45 million to the large national contractor that undertakes projects for the construction of government and private facilities. CNA Surety has provided significant surety bond protection for this contractor's projects through surety bonds underwritten by CCC or its affiliates. The loans were provided by CNAF to help the contractor meet its liquidity needs. The loans are evidenced by demand notes and, until replaced by the credit facility described below, accrue interest at 10%. The owners of the contractor have pledged to CNAF substantially all the assets of the contractor as collateral for these loans.

In March 2003, CNA Financial Corporation ("CNAF") entered into a credit agreement with the large national contractor, which undertakes projects for the construction of government and private facilities, to

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provide loans to the contractor in a maximum aggregate amount of \$86.4 million (the "Credit Facility"). Of the \$86.4 million capacity, \$74.8 million, including accrued interest, was outstanding at September 30, 2003. The Credit Facility and all related loans will mature in March, 2006. Advances under the Credit Facility bear interest at the prime rate plus 6%. Payment of 3% of the interest is deferred until the Credit Facility matures, and the remainder is to be paid monthly in cash. Loans under the Credit Facility are secured by a pledge of substantially all of the assets of the contractor and certain affiliates.

In addition, in June of 2003, CNAF and one of its subsidiaries provided repayment guarantees to certain creditors of the contractor and a subsidiary of the contractor. Such guarantees were provided in order to allow the contractor to receive financial accommodations from a creditor and in order to comply with certain regulatory requirements. Under the terms of the guarantees, any payments



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made by CNAF, or any of its subsidiaries, would be considered a draw under the Credit Facility. As of September 30, 2003 these guarantees amounted to \$7.4 million.

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

In March of 2003, CNAF also purchased the contractor's outstanding bank debt for \$16.4 million. The contractor retired the bank debt by paying CNAF \$16.4 million, with \$11.4 million of the payoff amount being funded under the new Credit Facility and \$5 million from money loaned to the contractor by its shareholders. Under its purchase agreement with the banks, CNAF was also required to reimburse the banks for any draws upon approximately \$6.5 million in outstanding letters of credit issued by the banks for the contractor's benefit that were due to expire between May and August of 2003. One of these letters of credit in the amount of \$3.4 million was extended, but on September 30, 2003 was due to expire on November 1, 2003. Any amounts paid by CNAF to the banks as reimbursements for draws upon the banks' letters of credit would become obligations of the contractor to CNAF as draws upon the Credit Facility.

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

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

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

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

## Related Party Reinsurance

Intercompany reinsurance agreements together with the Services and Indemnity Agreement that are described below provide for the transfer of the surety business written by CCC and CIC to Western Surety. All these agreements originally were entered into on September 30, 1997 (the "Merger Date"): (i) the Surety Quota Share Treaty (the "Quota Share Treaty"); (ii) the Aggregate Stop Loss Reinsurance Contract (the "Stop Loss Contract"); and (iii) the Surety Excess of Loss Reinsurance Contract (the "Excess of Loss Contract"). All of these contracts have expired. Some have been renewed on different terms as described below.

The Services and Indemnity Agreement provides the Company's insurance subsidiaries with the authority to perform various administrative, management, underwriting and claim functions in order to conduct the business of CCC and CIC and to be reimbursed by CCC for services rendered. In consideration for providing the foregoing services, CCC has agreed to pay Western Surety a quarterly fee of \$50,000. This agreement expires on December 31, 2003; and is annually renewable thereafter. There was no amount due to the CNA Surety insurance subsidiaries as of September 30, 2003.

Through the Quota Share Treaty, CCC and CIC transfer to Western Surety all surety business written or renewed by CCC and CIC after the Merger Date. CCC and CIC transfer the related liabilities of such business and pay to Western Surety an amount in cash equal to CCC's and CIC's net written premiums written on all such business, minus a quarterly ceding commission to be retained by CCC and CIC equal to \$50,000 plus 28% of net written premiums written on such business.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of September 30, 1997 by agreeing to pay Western Surety, within 30 days following the end of each calendar quarter, the amount of any adverse development on such reserves, as reestimated as of the end of such calendar quarter. There was not any adverse reserve development for the period from September 30, 1997 (date of inception) through September 30, 2003.

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

The Stop Loss Contract terminated on December 31, 2000 and was not renewed. The Stop Loss Contract protected the insurance subsidiaries from adverse loss experience on certain business underwritten after the Merger Date. The Stop Loss Contract between the insurance subsidiaries and CCC limited the insurance subsidiaries' prospective net loss ratios with respect to certain accounts and lines of insured business for three full accident years following the Merger Date. In the event the insurance subsidiaries' accident year net loss ratio exceeds 24% in any of 1997 through 2000 on certain insured accounts (the "Loss Ratio Cap"), the Stop Loss Contract requires CCC at the end of each calendar quarter following the Merger Date, to pay to the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which their actual accident year net loss ratio exceeds the applicable Loss Ratio Cap, multiplied by (ii) the applicable net earned premiums. In consideration for the coverage provided by the Stop Loss Contract, the insurance subsidiaries paid to CCC an annual premium of \$20,000. The CNA Surety insurance subsidiaries have paid CCC all required annual premiums. As of September 30, 2003, the Company had an estimated

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unpaid loss recoverable balance of approximately \$37.0 million under the Stop Loss Contract of which \$28.0 million has been billed.

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

Effective October 1, 2002, the Company secured replacement excess of loss protection from CCC for per principal losses that exceed \$60 million in two parts - a) \$40 million excess of \$60 million and b) \$50 million excess of \$100 million. This excess of loss protection is primarily necessary to support contract surety accounts with bonded backlogs or work-in-process in excess of \$60 million. The Company generally limits support to large commercial surety accounts to \$25 million. In addition to the foregoing structural changes in its high layer excess of loss reinsurance programs, the cost for these protections increased significantly as compared to the cost of the previous two Excess of Loss Contracts. The \$40 million excess of \$60 million contract is for a three year term beginning October 1, 2002 and provides annual aggregate coverage of \$80 million and \$120 million aggregate coverage for the entire three year term. The Company paid annual reinsurance premiums of \$12.5 million in year one to CCC. Effective October 1, 2003, the \$40 million excess of \$60 million contract was amended to extend the year one quarterly premium rate of \$3.125 million and commutation provision for an additional quarter ending December 31, 2003. The Company is seeking to obtain replacement coverage with third party reinsurers effective January 1, 2004. The Company will pay CCC a total of \$17.5 million in years two and three, payable quarterly. The Company may commute the contract at the end of each contract year and at the beginning of each calendar year under certain circumstances. If the treaty is commuted, the Company may be entitled to a return premium payment. Based on the experience under the treaty to September 30, 2003, the Company has established a return premium receivable of \$8.8 million in connection with the restatement described in Note 7. The reinsurance premium for the coverage provided by the \$50 million excess of \$100 million contract was \$6.0 million. This contract expires on December 31, 2003.

Effective October 1, 2003, pending state insurance department regulatory approval, the Company entered into a \$3 million excess of \$12 million excess of loss contract with CCC. The reinsurance premium for the coverage provided by the \$3 million excess of \$12 million contract is \$0.3 million plus, if applicable, additional premiums based on paid losses. The contract provides for aggregate coverage of \$12 million. This contract expires on December 31, 2004. This contract effectively lowers the Company's net retention on new bonds for the

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remainder of 2003 to \$12 million plus a 5% co-participation in the \$45 million layer of excess reinsurance with third party reinsurers.

As of September 30, 2003 and December 31, 2002, CNA Surety had insurance receivable balances from CCC and CIC of \$68.5 million and \$51.7 million, respectively. CNA Surety had reinsurance

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payables to CCC and CIC of \$1.3 million and \$21.3 million as of September 30, 2003 and December 31, 2002, respectively, primarily related to reinsured losses.

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 End	
	September 30,	
	2003	2002
	-----	-----
Reserves at beginning of period:		
Gross .....	277,210	\$30,000
Ceded reinsurance .....	116,456	14,000
	-----	-----
Net reserves at beginning of period .....	\$160,754	16,000
	=====	-----
Net incurred loss and loss adjustment expenses:		
Provision for insured events of current period .....	73,531	3,000
Increase in provision for insured events of prior periods .....	38,961	0
	-----	-----
Total net incurred .....	112,492	3,000
	-----	-----
Net payments attributable to:		
Current period events .....	19,753	0
Prior period events .....	7,039	1,000
	-----	-----
Total net payments .....	26,792	2,000
	-----	-----
Net reserves at end of period .....	246,454	17,000
Ceded reinsurance at end of period .....	138,452	16,000
	-----	-----
Gross reserves at end of period .....	\$384,906	\$33,000
	=====	=====

The Company recorded net unfavorable loss reserve development which resulted in increases in the estimated liability of \$39.3 million for the nine months ended September 30, 2003. This increase primarily relates to accident years 2002 and 2001 and changes in estimates of potential additional losses resulting from material adverse claim activity in the third quarter of 2003.

In addition to the net unfavorable loss reserve development in the third

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quarter of 2003, the higher net loss ratio in 2003 primarily relates to net reserve additions in the quarter of approximately \$49.0 million for the current accident year due to material adverse loss severity in the third quarter of 2003 on the Company's branch commercial and contract business.

On January 2, 2003, CNA Surety settled litigation brought by J.P. Morgan Chase & Co. ("Chase") in connection with three surety bonds issued on behalf of Enron Corporation subsidiaries. The penal sums of the three bonds totaled approximately \$78 million. Although the Company believed it had valid defenses to the litigation, based on the uncertainty and risk of an adverse jury verdict, pursuant to the settlement agreement, the Company paid Chase approximately \$40.7 million and assigned its recovery rights in the Enron bankruptcy to Chase in exchange for a full release of its obligations under the bonds. The Company has no other exposure related to the Enron Corporation. CNA Surety's net loss related to the settlement, after anticipated recoveries under excess of loss reinsurance treaties, was previously fully reserved. Immediately upon execution of the settlement documents, the Company sent written notice for reimbursement to its reinsurers. As of September 30, 2003, the Company has billed a total of \$37.1 million to its reinsurers. Four reinsurers responsible for payment of 46% of the treaty proceeds have paid or have agreed to pay their portions of the claim. Two other reinsurers have sent the Company letters expressing reservations about the claim. One reinsurer has denied coverage. Pursuant to the treaty, the Company has sent a notice demanding arbitration to all the reinsurers that have not paid. Management believes none of the reinsurers have valid defenses under the reinsurance treaties to avoid payment, and

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that the Company will fully recover all reinsurance recoverables recorded related to this settlement. As such, the Company has not recorded a reduction with respect to these reinsurance recoverables as of September 30, 2003.

### 5. DEBT

On September 30, 2002, the Company refinanced \$65 million in outstanding borrowings under its previous credit facility with a new credit facility (the "2002 Credit Facility"). The 2002 Credit Facility, as amended September 30, 2003, provides an aggregate of up to \$50 million in borrowings divided between a revolving credit facility (the "Revolving Credit Facility") of \$30 million and a term loan facility (the "Term Loan") of \$20 million. The Revolving Credit Facility matures on September 30, 2005. The Revolving Credit Facility may be increased from time to time by the amount of amortization under the Term Loan facility up to an additional \$10 million. Such increase is subject to consent by each Revolving Credit Bank, and will take place upon receipt by the Banks of the respective installment payments under the Term Loan facility.

Effective January 30, 2003, the Company entered into an interest rate swap on the Term Loan. As a result, the current effective interest rate on the term loan as of September 30, 2003 was 2.83%.

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

Date

----

Amortization

-----

Outstanding

-----

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March 31, 2004.....	\$5,000,000	\$15,000,000
September 30, 2004.....	5,000,000	10,000,000
March 31, 2005.....	5,000,000	5,000,000
September 30, 2005.....	5,000,000	

The interest rate on borrowings under the 2002 Credit Facility may be fixed, at CNA Surety's option, for a period of one, two, three, or six months and is based on, among other rates, the London Interbank Offered Rate ("LIBOR"), plus the applicable margin. The margin, including a facility fee and utilization fee on the Revolving Credit Facility, was 1.30% at September 30, 2003 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 1.15% to 1.45%. The margin on the Term Loan, was 0.625% at September 30, 2003 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 0.48% to 0.80%. As of September 30, 2003, the weighted average interest rate was 2.7% on the \$50 million of outstanding borrowings. As of December 31, 2002, the weighted average interest rate on the 2002 Credit Facility was 2.0% on the \$60 million of outstanding borrowings.

The 2002 Credit Facility contains, among other conditions, limitations on CNA Surety with respect to the incurrence of additional indebtedness and maintenance of a rating of at least "A" by A.M. Best Company Inc. for each of the Company's insurance subsidiaries. The 2002 Credit Facility also requires the maintenance of certain financial ratios as follows: a) maximum funded debt to total capitalization ratio of 25%, b) minimum net worth of \$350.0 million and c) minimum fixed charge coverage ratio of 2.5 times. At September 30, 2003 and December 31, 2002, CNA Surety was in compliance with all restrictive debt covenants, except for the fixed charge coverage ratio for the period ended September 30, 2003 for which CNA Surety obtained a waiver from the lenders. The lenders amended the 2002 Credit Facility to replace the fixed charge coverage ratio requirement for the next three quarters with a minimum earnings

requirement.

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 September 30, 2003 was \$0.4 million.

The consolidated balance sheet reflects total debt of \$50.4 million at September 30, 2003 and \$60.8 million at December 31, 2002. The weighted average interest rate on outstanding borrowings was 2.5% and 2.0% at September 30, 2003 and December 31, 2002 respectively.

### 6. COMMITMENTS AND CONTINGENCIES

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

### 7. RESTATEMENT

Subsequent to the filing of CNA Surety's Report on Form 10-Q for the fiscal quarter ended September 30, 2003, the Company revised its accounting for ceded premiums under a multiple year excess of loss reinsurance treaty with its

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affiliate, Continental Casualty Company, which has been in place since October 1, 2002. Under the contract CNA Surety pays a quarterly premium of \$3.125 million, of which 70% is added to an experience account that is reduced by any losses ceded to the treaty. On dates specified under the contract, CNA Surety can commute the treaty and receive payment of the experience account balance. Under Emerging Issues Task Force ("EITF") Issue 93-6 "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises" ("EITF 93-6"), a receivable for return premium based on experience under the contract should be established at September 30, 2003. CNA Surety had not previously established such a receivable, and has restated its condensed consolidated financial statements to comply with EITF 93-6. A summary of the significant effects of the restatement is as follows:

FOR THE PERIODS ENDED: (IN THOUSANDS)	AS PREVIOUSLY REPORTED SEPTEMBER 30, 2003 -----	AS RESTATEd SEPTEMBER 30, 2003 -----
Consolidated balance sheet:		
Insurance receivables: Reinsurance	\$ 153,196	\$ 161,948
Current income taxes receivable	28,099	25,035
Retained earnings	129,502	135,190

FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30 (in thousands, except per share data)	AS PREVIOUSLY REPORTED 2003 -----	AS RESTATEd 2003 -----
	----- Three months ended September 30 -----	
Consolidated statement of income:		
Net earned premium	\$ 75,544	\$ 77,732
Total revenue	81,974	84,162
Loss before income taxes	(79,695)	(77,507)
Income tax benefit	(30,854)	(30,088)
Net loss	(48,841)	(47,419)
Basic and diluted loss per share	(\$1.14)	(\$1.10)

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### CNA SURETY CORPORATION AND SUBSIDIARIES

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

##### GENERAL

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

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### RESTATEMENT

Subsequent to the filing of CNA Surety's Report on Form 10-Q for the fiscal quarter ended September 30, 2003, the Company revised its accounting for ceded premiums under a multiple year excess of loss reinsurance treaty with its affiliate, Continental Casualty Company, which has been in place since October 1, 2002 (this treaty is discussed in greater detail in Note 3 (Reinsurance)). Under the contract CNA Surety pays a quarterly premium of \$3.125 million, of which 70% is added to an experience account that is reduced by any losses ceded to the treaty. On dates specified under the contract, CNA Surety can commute the treaty and receive payment of the experience account balance. Under Emerging Issues Task Force ("EITF") Issue 93-6 "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises" ("EITF 93-6"), a receivable for return premium based on experience under the contract should be established at September 30, 2003. CNA Surety had not previously established such a receivable, and has restated its condensed consolidated financial statements to comply with EITF 93-6. See Note 7 to the Condensed Consolidated Financial Statements. This Management's Discussion and Analysis reflects the effects of the restatement.

### CRITICAL ACCOUNTING POLICIES

Management believes the most significant accounting policies and related disclosures for purposes of understanding the Company's results of operations and financial condition pertain to investments, deferred acquisition costs, goodwill and other intangible assets, reserves for unpaid losses and loss adjustment expenses and reinsurance. The Company's accounting policies related to reserves for unpaid losses and loss adjustment expenses and related estimates of reinsurance recoverables, are particularly critical to an assessment of the Company's financial results. These areas are highly subjective and require management's most complex judgments because of the need to make estimates about the effects of matters that are inherently uncertain.

### Investments

Management believes the Company has the ability to hold all fixed income securities to maturity. However, the Company may dispose of securities prior to their scheduled maturity due to changes in interest rates, prepayments, tax and credit considerations, liquidity or regulatory capital requirements, or other similar factors. As a result, the Company considers all of its fixed income securities (bonds and redeemable preferred stocks) and equity securities as available-for-sale. These securities are reported at

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fair value, with unrealized gains and losses, net of deferred income taxes, reported as a separate component of stockholders' equity. Cash flows from purchases, sales and maturities are reported gross in the investing activities section of the cash flow statement.

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



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realized investment gains and losses.

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

### Deferred Policy Acquisition Costs

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

### Goodwill and Other Intangible Assets

CNA Surety's Consolidated Balance Sheet as of September 30, 2003 includes goodwill and identified intangibles of approximately \$138.8 million. The goodwill and intangible balance as of September 30, 2003 reflects a \$5 million reduction in goodwill in the third quarter of 2003 resulting from a change in estimate with respect to pre-acquisition income taxes. These amounts represent goodwill and identified intangibles arising from the acquisition of Capsure Holdings Corp. ("Capsure"). Prior to 2002, goodwill from this and other acquisitions was generally amortized as a charge to earnings over periods not exceeding 30 years. Under Statement of Financial Accounting Standards ("SFAS") No. 142 entitled "Goodwill and Other Intangible Assets" ("SFAS No. 142"), which was adopted by CNA Surety as of January 1, 2002, periodic amortization ceased, in accordance with an impairment-only accounting model.

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

### Reserves for Unpaid Losses and Loss Adjustment Expenses and Reinsurance

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

claims have not yet been reported and some claims may not be reported for many years. As a result, the liability for unpaid losses includes significant estimates for incurred-but-not-reported claims. Additionally, reported claims are in various stages of the settlement process. Each claim is settled individually based upon its merits, and certain claim liabilities may take years

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to settle, especially if legal action is involved.

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

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

CNA Surety's Consolidated Balance Sheet includes estimated liabilities for unpaid losses and loss adjustment expenses of \$384.9 million and reinsurance receivables related to losses of \$138.5 million at September 30, 2003. Due to the inherent uncertainties in the process of establishing these amounts, the actual ultimate claims amounts will differ from the currently recorded amounts. An incremental percentage change in estimates of this magnitude could result in a material effect on reported earnings. For example, a 10% increase in the September 30, 2003 net estimate for unpaid losses and loss adjustment expenses would produce approximately a \$24.6 million charge to pre-tax earnings. Future effects from changes in these estimates will be recorded as a component of losses incurred in the period such changes are determined to be needed.

### FORMATION OF CNA SURETY AND MERGER

In December 1996, CNA Financial Corporation ("CNAF") and Capsure agreed to merge (the "Merger") the surety business of CNAF with Capsure's insurance subsidiaries, Western Surety Company ("Western Surety") and Universal Surety of America ("USA"), into CNA Surety. CNAF, through its operating subsidiaries, writes multiple lines of property and casualty insurance, including surety business that is reinsured by Western Surety. CNAF owns approximately 64% of the outstanding common stock of CNA Surety. Loews Corporation ("Loews") owns approximately 90% of the outstanding common stock of CNAF. The principal operating subsidiaries of CNAF that wrote the surety line of business for their own account prior to the Merger were Continental Casualty Company and its property and casualty affiliates (collectively, "CCC") and The Continental Insurance Company and its property and casualty affiliates (collectively, "CIC"). CIC was acquired by CNAF on May 10, 1995. The combined surety operations of CCC and CIC are referred to herein as CCC Surety Operations.

### BUSINESS

CNA Surety's insurance subsidiaries write surety and fidelity bonds in all 50 states through a combined network of approximately 34,000 independent agencies. CNA Surety's principal insurance subsidiary is Western Surety. The insurance subsidiaries write, on a direct basis or as business assumed

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

### FINANCIAL STRENGTH RATINGS

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

Western Surety is currently rated A (Excellent) with a negative rating outlook, by A.M. Best. An A (Excellent) rating is assigned to those companies which A.M. Best believes have an excellent ability to meet their ongoing obligations to policyholders. A (Excellent) rated insurers have been shown to be among the strongest in ability to meet policyholder and other contractual obligations. The rating outlook indicates the potential direction of a company's rating for an intermediate period, generally defined as the next 12 to 36 months. Through intercompany reinsurance and related agreements, CNA Surety's customers have access to CCC's broader underwriting capacity. CCC is currently rated A (Excellent) by A.M. Best. A.M. Best's letter ratings range from A++ (Superior) to F (In Liquidation) with A++ being highest.

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

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

### 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. You can identify forward-looking statements because generally they include words such as "believes," "expects," "intends," "anticipates," "estimates," and similar expressions. Forward-looking statements in this report include expected developments in the Company's insurance business, including losses and loss reserves; the impact of routine ongoing insurance reserve reviews being conducted by the Company; the ongoing state regulatory examinations of the Company's primary insurance company subsidiaries, and the Company's responses to the results of those reviews and examinations; the Company's expectations concerning its revenues, earnings, expenses and investment activities; expected cost savings and other results from the Company's expense reduction and restructuring activities; and the Company's proposed actions in response to trends in its business.

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

- general economic and business conditions;

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

### RESULTS OF OPERATIONS

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### Financial Measures

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

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statement amounts, are considered a non-GAAP financial measure and are used by management to monitor performance of the Company's insurance operations. The Company's investment portfolio is monitored through analysis of various quantitative and qualitative factors and certain decisions related to the sale or impairment of investments produce realized gains and losses, which is also a component used in the calculation of net income and is a non-GAAP financial measure.

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

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

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

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 its 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.

CNA SURETY RESULTS FOR THREE- AND NINE- MONTHS ENDED SEPTEMBER 30, 2003 AND 2002

Analysis of Net Income (Loss)

The Company had a net loss of \$47.4 million for the three months ended September 30, 2003, as compared to net income of \$2.6 million for the comparable period in the prior year. The principal drivers of the difference in net income from period to period were an increase in the Company's net losses, commissions and related expenses, partially offset by increased net earned premiums for the three months ended September 30, 2003, compared to the three months ended September 30, 2002.

Net loss for the nine months ended September 30, 2003 was \$24.7 million, compared to net income of \$26.1 million for the comparable period last year. As with the three month period ended September 30, 2003, the principal drivers of the decrease in net income for the nine month periods were an increase in net losses, commissions and related expenses, partially offset by increased net earned premiums.

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

Results of Insurance Operations

Underwriting components for the Company for the three and nine months ended September 30, 2003 and 2002 are summarized in the following table (dollars in thousands):

	Three Months Ended September 30,	
	2003	2002
Gross written premiums .....	\$ 94,222	\$ 97,029
Net written premiums .....	\$ 82,138	\$ 86,386
Net earned premiums .....	\$ 77,732	\$ 79,196
Net losses and loss adjustment expenses .....	\$ 112,492	\$ 35,380
Net commissions, brokerage and other underwriting expenses .....	\$ 48,805	\$ 46,027
Loss ratio .....	144.7%	44.7%
Expense ratio .....	62.8	58.1
Combined ratio .....	207.5%	102.8%

## Premiums Written

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Contract .....	\$ 56,863	\$ 55,503	\$157,651	\$147,800
Commercial .....	29,970	34,630	103,145	103,145
Fidelity and other .....	7,389	6,896	22,543	22,543
	-----	-----	-----	-----
	\$ 94,222	\$ 97,029	\$283,339	\$273,488
	=====	=====	=====	=====

Gross written premiums decreased 2.9%, or \$2.8 million, for the three months ended September 30, 2003 over the comparable period in 2002. Contract surety gross written premiums increased 2.5%, or \$1.4 million, as compared to 2002 primarily due to improving rates. Commercial surety in the third quarter of 2003 decreased by \$4.7 million, or 13.5%, due to the Company's ongoing efforts to reduce aggregate exposures to large commercial accounts. In the third quarter of 2003, the Company experienced continued volume growth of small commercial products along with improving rates on large commercial and contract bonds. The estimated impact of the Company's large commercial account exposure reduction of \$2.1 billion for the first nine months of 2003 represents approximately \$9.5 million in annual premium, assuming an average rate per \$1,000 of bond exposure of \$4.52, or 45 basis points. Fidelity and other products increased 7.1%, or \$0.5 million, to \$7.4 million for the three months ended September 30, 2003 as compared to the same period in 2002 due primarily to volume growth in fidelity and E&O products.

Gross written premiums increased 3.2%, or \$8.7 million, for the nine months ended September 30, 2003 over the comparable period in 2002. Gross written premiums for contract surety increased 6.0%, or \$8.9 million and commercial surety decreased 1.4%, or \$1.5 million for the nine months ended September 30, 2003 reflecting trends comparable to those previously discussed for the third quarter 2003. Fidelity

and other products increased 6.3% to \$22.5 million for the nine months ended September 30, 2003 as compared to the same period in 2002 due primarily to volume growth in fidelity and E&O products.

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

	Three Months Ended September 30,	
	2003	2002
Contract.....	\$ 51,492	\$ 50,527
Commercial.....	23,602	29,289
Fidelity and other.....	7,044	6,570
	\$ 82,138	\$ 86,386

For the three months ended September 30, 2003, net written premiums decreased 4.9%, or \$4.2 million, to \$82.1 million as compared to the same period in 2002, reflecting higher reinsurance costs partially offset by the aforementioned gross production changes. Ceded written premiums increased \$1.4 million to \$12.1 million for the third quarter of 2003 compared to the same period of last year primarily due to changes in the Company's reinsurance programs as more fully described below. Net written premiums for contract surety business increased 1.9%, or \$1.0 million, to \$51.5 million. Net written premiums for commercial surety decreased 19.4%, or \$5.7 million, to \$23.6 million for the three months ended September 30, 2003. Fidelity and other products increased 7.2%, or \$0.5 million, to \$7.0 million for the three months ended September 30, 2003 as compared to the same period in 2002.

For the nine months ended September 30, 2003, net written premiums increased 3.2% to \$244.8 million as compared to the same period in 2002, reflecting the aforementioned gross production changes partially offset by effects of higher reinsurance costs. Ceded written premiums increased \$1.1 million to \$38.6 million for the nine months ended September 30, 2003. Net written premiums for contract surety business increased 6.6% to \$140.4 million. Net written premiums for commercial surety decreased 2.8% to \$82.9 million for the first nine months in 2003. Fidelity and other products increased 6.4% to \$21.5 million for the first nine months in 2003 as compared to the same period in 2002.

Excess of Loss Reinsurance

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

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

2003 Third Party Reinsurance Compared to 2002 Third Party Reinsurance



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

The contract also includes similar special acceptance provisions for larger contract accounts contained in the 2002 Excess of Loss Treaty. In addition to the one large national contract principal and the two commercial principals excluded (based upon class of business in 2002), the Company's reinsurers have also excluded three other contract principals from the 2003 Excess of Loss Treaty for a total of six excluded principals. Of the two commercial principals, one is a domestic electric utility with an estimated bonded exposure of \$53 million and is currently rated B by Standard and Poor's ("S&P"). The bonded exposure will decline over the term of the bond which extends until 2007. The other is a foreign industrial enterprise with an estimated bonded exposure of \$31 million. The remaining \$31 million of the bonded exposure is expected to be discharged by June 30, 2004. With respect to the three contract principals other than the large national contractor (described below), two principals have substantially completed asset sales, debt reductions and other reorganization efforts. Each of these four principals continues to perform their contractual obligations underlying the Company's surety bonds.

The third contract principal went into claim in the second quarter of 2003. Although in claim and experiencing financial difficulties, the contractor continued to perform substantially all of its contractual obligations underlying the Company's surety bonds. This contractor recently filed for bankruptcy in late September, 2003. This filing increased the likelihood that the contractor will be unable to perform all of its contractual obligations. Based upon currently available information, management believes its net exposure to loss on this contractor could be up to \$15 million. This loss exposure has been considered in the Company's \$49 million net reserve addition in the third quarter of 2003 for the 2003 accident year.

In March 2003, CNA Financial Corporation ("CNAF") entered into a credit agreement with the large national contractor, which undertakes projects for the construction of government and private facilities, to provide loans to the contractor in a maximum aggregate amount of \$86.4 million (the "Credit Facility"). Of the \$86.4 million capacity, \$74.8 million, including accrued interest, was outstanding at September 30, 2003. The Credit Facility and all related loans will mature in March, 2006. Advances under the Credit Facility bear interest at the prime rate plus 6%. Payment of 3% of the interest is deferred until the Credit Facility matures, and the remainder is to be paid monthly in cash. Loans under the Credit Facility are secured by a pledge of substantially all of the assets of the contractor and certain affiliates.

In addition, in June of 2003, CNAF and one of its subsidiaries provided repayment guarantees to certain creditors of the contractor and a subsidiary of

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the contractor. Such guarantees were provided in order to allow the contractor to receive financial accommodations from a creditor and in order to comply with certain regulatory requirements. Under the terms of the guarantees, any payments made by CNAF, or any of its subsidiaries, would be considered a draw under the Credit Facility. As of September 30, 2003 these guarantees amounted to \$7.4 million.

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

In December 2002 and January 2003, CNAF provided loans in an aggregate amount of approximately \$45 million to the large national contractor that undertakes projects for the construction of government and private facilities. CNA Surety has provided significant surety bond protection for this contractor's projects through surety bonds underwritten by CCC or its affiliates. The loans were provided by CNAF to help the contractor meet its liquidity needs. The loans are evidenced by demand notes and, until replaced by the credit facility described below, accrue interest at 10%. The owners of the contractor have pledged to CNAF substantially all the assets of the contractor as collateral for these loans.

In March of 2003, CNAF also purchased the contractor's outstanding bank debt for \$16.4 million. The contractor retired the bank debt by paying CNAF \$16.4 million, with \$11.4 million of the payoff amount being funded under the new Credit Facility and \$5 million from money loaned to the contractor by its shareholders. Under its purchase agreement with the banks, CNAF was also required to reimburse the banks for any draws upon approximately \$6.5 million in outstanding letters of credit issued by the banks for the contractor's benefit that were due to expire between May and August of 2003. One of these letters of credit in the amount of \$3.4 million was extended, but on September 30, 2003 was due to expire on November 1, 2003. Any amounts paid by CNAF to the banks as reimbursements for draws upon the banks' letters of credit would become obligations of the contractor to CNAF as draws upon the Credit Facility.

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

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

Indemnification and subrogation rights, including rights to contract proceeds on construction projects in the event of default, exist that reduce CNA

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

### Related Party Reinsurance

Intercompany reinsurance agreements together with the Services and Indemnity Agreement that are described below provide for the transfer of the surety business written by CCC and CIC to Western Surety. All these agreements originally were entered into on September 30, 1997 (the "Merger Date"): (i) the Surety Quota Share Treaty (the "Quota Share Treaty"); (ii) the Aggregate Stop Loss Reinsurance Contract (the "Stop Loss Contract"); and (iii) the Surety Excess of Loss Reinsurance Contract (the "Excess of Loss Contract"). All of these contracts have expired. Some have been renewed on different terms as described below.

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The Services and Indemnity Agreement provides the Company's insurance subsidiaries with the authority to perform various administrative, management, underwriting and claim functions in order to conduct the business of CCC and CIC and to be reimbursed by CCC for services rendered. In consideration for providing the foregoing services, CCC has agreed to pay Western Surety a quarterly fee of \$50,000. This agreement expires on December 31, 2003; and is annually renewable thereafter. There was no amount due to the CNA Surety insurance subsidiaries as of September 30, 2003.

Through the Quota Share Treaty, CCC and CIC transfer to Western Surety all surety business written or renewed by CCC and CIC after the Merger Date. CCC and CIC transfer the related liabilities of such business and pay to Western Surety an amount in cash equal to CCC's and CIC's net written premiums written on all such business, minus a quarterly ceding commission to be retained by CCC and CIC equal to \$50,000 plus 28% of net written premiums written on such business.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of September 30, 1997 by agreeing to pay Western Surety, within 30 days following the end of each calendar quarter, the amount of any adverse development on such reserves, as re-estimated as of the end of such calendar quarter. There was not any adverse reserve development for the period from September 30, 1997 (date of inception) through September 30, 2003.

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

The Stop Loss Contract terminated on December 31, 2000 and was not renewed. The Stop Loss Contract protected the insurance subsidiaries from adverse loss experience on certain business underwritten after the Merger Date. The Stop Loss Contract between the insurance subsidiaries and CCC limited the

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insurance subsidiaries' prospective net loss ratios with respect to certain accounts and lines of insured business for three full accident years following the Merger Date. In the event the insurance subsidiaries' accident year net loss ratio exceeds 24% in any of 1997 through 2000 on certain insured accounts (the "Loss Ratio Cap"), the Stop Loss Contract requires CCC at the end of each calendar quarter following the Merger Date, to pay to the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which their actual accident year net loss ratio exceeds the applicable Loss Ratio Cap, multiplied by (ii) the applicable net earned premiums. In consideration for the coverage provided by the Stop Loss Contract, the insurance subsidiaries paid to CCC an annual premium of \$20,000. The CNA Surety insurance subsidiaries have paid CCC all required annual premiums. As of September 30, 2003, the Company had an estimated unpaid loss recoverable balance of approximately \$37.0 million under the Stop Loss Contract of which \$28.0 million has been billed.

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

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

Effective October 1, 2002, the Company secured replacement excess of loss protection from CCC for per principal losses that exceed \$60 million in two parts - a) \$40 million excess of \$60 million and b) \$50 million excess of \$100 million. This excess of loss protection is primarily necessary to support contract surety accounts with bonded backlogs or work-in-process in excess of \$60 million. The Company generally limits support to large commercial surety accounts to \$25 million. In addition to the foregoing structural changes in its high layer excess of loss reinsurance programs, the cost for these protections increased significantly as compared to the cost of the previous two Excess of Loss Contracts. The \$40 million excess of \$60 million contract is for a three year term beginning October 1, 2002 and provides annual aggregate coverage of \$80 million and \$120 million aggregate coverage for the entire three year term. The Company paid annual reinsurance premiums of \$12.5 million in year one to CCC .. Effective October 1, 2003, the \$40 million excess of \$60 million contract was amended to extend the year one quarterly premium rate of \$3.125 million and commutation provision for an additional quarter ending December 31, 2003. The Company is seeking to obtain replacement coverage with third party reinsurers effective January 1, 2004. The Company will pay CCC a total of \$17.5 million in years two and three, payable quarterly. The Company may commute the contract at the end of each contract year and at the beginning of each calendar year under

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certain circumstances. If the treaty is commuted, the Company may be entitled to a return premium payment. Based on the experience of the treaty to September 30, 2003, the Company has established a return premium receivable of \$8.8 million in connection with the restatement described in Note 7 to the accompanying financial statements. The reinsurance premium for the coverage provided by the \$50 million excess of \$100 million contract was \$6.0 million. This contract expires on December 31, 2003.

Effective October 1, 2003, pending state insurance department regulatory approval the Company entered into a \$3 million excess of \$12 million excess of loss contract with CCC. The reinsurance premium for the coverage provided by the \$3 million excess of \$12 million contract is \$0.3 million plus, if applicable, additional premiums based on paid losses. The contract provides for aggregate coverage of \$12 million. This contract expires on December 31, 2004. This contract effectively lowers the Company's net retention on new bonds for the remainder of 2003 to \$12 million plus a 5% co-participation in the \$45 million layer of excess reinsurance with third party reinsurers.

As of September 30, 2003 and December 31, 2002, CNA Surety had insurance receivable balances from CCC and CIC of \$68.5 million and \$51.7 million, respectively. CNA Surety had reinsurance payables to CCC and CIC of \$1.3 million and \$21.3 million as of September 30, 2003 and December 31, 2002, respectively, primarily related to reinsured losses.

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### Net Loss Ratio

The net loss ratios for the three months ended September 30, 2003 and 2002 were 144.7% and 44.7%, respectively. The loss ratios included \$39.0 million and \$4.2 million of net unfavorable loss reserve development related to prior years for the three months ended September 30, 2003 and 2002, respectively. The net adverse development on prior accident years of \$39.0 million primarily relates to accident years 2001 and 2002 and changes in estimates of potential additional large losses resulting from the material adverse claim activity in the third quarter of 2003. This change in estimated net losses reflects the recent receipt of a \$5 million payment demand with respect to a \$45 million insurance program bond. The Company estimates its maximum additional net exposure with respect to this account at \$17 million. Net adverse development also includes approximately \$8 million of claims pertaining to self-insured workers' compensation bonds issued in the 1980's on behalf of companies now in bankruptcy. For the nine months ended September 30, 2003 and 2002, the net loss ratios were 67.0% and 32.2%, respectively. The loss ratios included \$39.3 million and \$5.1 million of net unfavorable reserve development related to prior years for the nine months ended September 30, 2003 and 2002, respectively.

In addition to the net unfavorable loss reserve development in the third quarter of 2003, the higher net loss ratio in 2003 primarily relates to net reserve additions in the quarter of approximately \$49.0 million for the current accident year due to material adverse loss severity in the third quarter of 2003 on the

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Company's branch commercial and contract business. The net additions to reserves for the current accident year primarily relate to two large claims totaling \$23 million incurred in the quarter and changes in estimates of potential additional large losses resulting from this significant adverse claim activity. Approximately \$15 million of net additions relate to a net loss with respect to

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an insurance program bond for a now bankrupt large commercial account. The other \$8 million relates to a contract claim. A portion of the remaining change in estimated net losses for the current accident year relates to a contractor that went into claim in the second quarter of 2003 for which the Company disclosed a loss contingency of up to \$15 million. These net additions to the 2003 accident year resulted in a 68.6% net loss ratio on the branch commercial and contract business for the first nine months of 2003. The Company was using an initial 2003 accident year net loss ratio of 36.0% for the medium to large commercial and contract branch business compared to 30.0% in the first nine months of 2002. This business represents about 43% of the Company's gross premiums for the third quarter of 2003 compared to 59% for the same period of 2002. This decline primarily reflects the considerable success achieved in shedding the more volatile and capital intensive large commercial account business.

On January 2, 2003, CNA Surety settled litigation brought by J.P. Morgan Chase & Co. ("Chase") in connection with three surety bonds issued on behalf of Enron Corporation subsidiaries. The penal sums of the three bonds totaled approximately \$78 million. Although the Company believed it had valid defenses to the litigation, based on the uncertainty and risk of an adverse jury verdict, pursuant to the settlement agreement, the Company paid Chase approximately \$40.7 million and assigned its recovery rights in the Enron bankruptcy to Chase in exchange for a full release of its obligations under the bonds. The Company has no other exposure related to the Enron Corporation. CNA Surety's net loss related to the settlement, after anticipated recoveries under excess of loss reinsurance treaties, was previously fully reserved. Immediately upon execution of the settlement documents, the Company sent written notice for reimbursement to its reinsurers. As of September 30, 2003, the Company has billed at total of \$37.1 million to its reinsurers. Four reinsurers responsible for payment of 46% of the treaty proceeds have paid or have agreed to pay their portions of the claim. Two other reinsurers have sent the Company letters expressing reservations about the claim. One reinsurer has denied coverage. Pursuant to the treaty, the Company has sent a notice demanding arbitration to all the reinsurers that have not paid. Management believes none of the reinsurers have valid defenses under the reinsurance treaties to avoid payment, and that the Company will fully recover all reinsurance recoverables recorded related to this settlement. As such, the Company has not recorded a reduction with respect to these reinsurance recoverables as of September 30, 2003.

Within the commercial surety segments, the Company has exposures related to a small number of accounts, which are now in various stages of bankruptcy proceedings. In addition, certain other accounts have experienced deterioration in creditworthiness since the Company issued bonds to them. Given the current economic climate and its impact on these companies, the Company may experience an increase in claims and, possibly, incur high severity losses. Such losses would be recognized in the period in which the claims are filed and determined to be a valid loss under the provisions of the surety bond issued.

### Expense Ratio

The expense ratio increased to 62.8% for the three months ended September 30, 2003 compared to 58.1% for the same period in 2002. For the nine months ended September 30, 2003, the expense ratio increased to 62.5% from 60.0% for the same period in 2002. The increase in the expense ratio for the three and nine months ended September 30, 2003 primarily reflects the impact of higher reinsurance costs on net earned premiums. Bad debt expense also increased \$1.0 million in the third quarter. Net earned premiums declined 1.8% and operating expenses increased 6.0% for the three months ended September 30, 2003. For

the nine months ended September 30, 2003, net earned premiums increased 1.6% and

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operating expenses increased at a higher rate of 5.9%.

### Exposure Management

The Company's business is subject to certain risks and uncertainties associated with the current economic environment and corporate credit conditions. In response to these risks and uncertainties, the Company has continued various exposure management initiatives, particularly to reduce its risks on large commercial accounts. As the following table depicts, the Company has reduced its exposure, before the effects of reinsurance, by 37% in 2003 on large commercial accounts, which are defined as accounts with exposures in excess of \$10 million:

Commercial Account Exposure	Number of Accounts As of		Total Exposure (dollars As of	
	September 30, 2003	December 31, 2002	September 30, 2003	December 31, 2002
\$100 million and larger	8	14	\$ 1.3	\$ 2.7
\$50 to \$100 million	8	19	0.6	1.2
\$25 to \$50 million	17	16	0.6	0.6
\$10 to \$25 million	70	75	1.1	1.2
	---	---	-----	-----
Total	103	124	\$ 3.6	\$ 5.7
	===	===	=====	=====

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

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

### Investment Income

For the three months ended September 30, 2003, net investment income was \$6.4 million compared to the three months ended September 30, 2002 of \$7.0 million. The decrease in investment income primarily reflects the impact of lower investment yields and greater investment in tax-exempt securities. The annualized pretax yields were 4.3% and 4.8% for the three months ended September 30, 2003 and 2002, respectively. The annualized after-tax yields for the Company's portfolio were 3.6% and 3.8% for the three months ended September 30, 2003 and 2002. Net investment income for the nine months ended September 30, 2003 and 2002 was \$19.8 million and \$21.3 million, respectively. The annualized pretax yields were 4.5% and 4.9% for the nine months ended September 30, 2003 and 2002. The annualized after-tax yields were 3.7% and 3.8% for the nine months ended September 30, 2003 and 2002.

Net realized investment gains were minimal for the three months ended September 30, 2003 compared to net realized investment losses of approximately \$0.7 million for the same period in 2002. Net realized investment gains were approximately \$1.8 million for the nine months ended September 30, 2003 compared

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to net realized investment gains of approximately \$0.6 for the same period in 2002.

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

	Three Months Ended September 30,		Nine Se
	2003	2002	20
Gross realized investment gains .....	\$ 2	\$ 1,882	\$ 2,
Gross realized investment losses .....	(1)	(2,580)	(
Net realized investment gains (losses) .....	\$ 1	\$ (698)	\$ 1,

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.

### Analysis of Other Operations

Interest expense for the three months ended September 30, 2003 decreased 8.6% as compared to the third quarter in 2002. Average debt outstanding was \$55.2 million for the third quarter of 2003 compared to \$65.9 million in the third of 2002. The weighted average interest rate for the three months ended

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September 30, 2003 was 2.3% compared to 2.1% for the same period in 2002. Interest expense decreased 9.9% for the first nine months of 2003 as compared to the same period in 2002. Average debt outstanding was \$59.0 million for the first nine months in 2003 compared to \$73.8 million in the first nine months of 2002. The weighted average interest rate for the nine months ended September 30, 2003 was 2.4% compared to 2.2% for the same period in 2002. The increases in the 2003 weighted average interest rates are primarily due to the Company's entrance into an interest rate swap on its \$30 million Term Loan. The current effective interest rate on the term loan after the effect of the interest rate swap was 2.83% as of September 30, 2003.

Income Taxes



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The Company's income tax benefit was \$30.1 million for the three months ended September 30, 2003 compared to income tax expense of \$1.1 million for the same period in 2002. The effective income tax rates were 38.8% and 29.6% for the three months ended September 30, 2003 and 2002, respectively. For the nine months ended September 30, 2003, the Company's income tax benefit was \$21.4 million compared to income tax expense of \$11.9 million for the same period in 2002. The effective income tax rates were 46.4% and 31.2%, respectively. The changes in the estimated effective tax rate in 2003 primarily relates to taxable losses and greater investments in tax exempt securities in 2003.

### LIQUIDITY AND CAPITAL RESOURCES

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

The Company believes that total invested assets, including cash and short-term investments, are sufficient in the aggregate and have suitably scheduled maturities to satisfy all policy claims and other operating liabilities, including dividend and income tax sharing payments of its insurance subsidiaries. At September 30, 2003, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of \$551.1 million of fixed income securities, \$29.7 million of short-term investments, \$1.1 million of other investments and \$3.1 million of cash. At December 31, 2002, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of \$564.8 million of fixed income securities, \$41.9 million of short-term investments, \$1.3 million of other investments and \$10.7 million of cash.

Cash flow at the parent company level is derived principally from dividend and tax sharing payments from its insurance subsidiaries. The principal obligations at the parent company level are to service debt, pay operating expenses, including income taxes, and pay dividends to stockholders. At September 30, 2003, the parent company's invested assets consisted of \$6.2 million of fixed income securities, \$0.9 million of equity securities, \$31.1 million of short-term investments and \$7.2 million of cash. At December 31, 2002, the parent company's invested assets consisted of \$5.7 million of fixed income securities, \$0.8 million of equity securities, \$8.8 million of short-term investments and \$4.3 million of cash. As of September 30, 2003 and December 31, 2002, parent company short-term investments and

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cash included \$15.2 million and \$4.8 million, respectively, of restricted cash related to premium receipt collections ultimately due to the Company's insurance subsidiaries.

The Company's consolidated net cash flow provided by operating activities was \$2.6 million for the nine months ended September 30, 2003 compared to net cash flow provided by operating activities of \$73.6 million for the comparable period in 2002. The decrease in net cash flow provided by operating activities primarily relates to increased net loss payments, primarily related to settlement of litigation brought by Chase in connection with three surety bonds

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issued on behalf of Enron Corporation subsidiaries, decreases in reinsurance and other payables to affiliates and increases in income taxes receivable.

The Company refinanced \$65 million in outstanding borrowings under its previous credit facility under a new credit facility (the "2002 Credit Facility"). The 2002 Credit Facility provides an aggregate of up to \$50 million in borrowings divided between a revolving credit facility (the "Revolving Credit Facility") of \$30 million and a term loan facility (the "Term Loan") of \$20 million. The Revolving Credit Facility matures on September 30, 2005. The Revolving Credit Facility may be increased from time to time by the amount of amortization under the Term Loan facility up to an additional \$10 million. Such increase is subject to consent by each Revolving Credit Bank, and will take place upon receipt by the Banks of the respective installment payments under the Term Loan facility.

Outstanding borrowings under the 2002 Credit Facility were \$50 million as of September 30, 2003, consisting of \$30 million under the Revolving Credit Facility and \$20 million under the Term Loan Facility. Effective January 30, 2003, the Company entered into an interest rate swap on the \$30 million Term Loan. As a result, the current effective interest rate on the term loan as of September 30, 2003 was 2.83%.

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

Date ----	Amortization -----	Outstanding Balance -----
March 31, 2004.....	\$5,000,000	\$15,000,000
September 30, 2004.....	5,000,000	10,000,000
March 31, 2005.....	5,000,000	5,000,000
September 30, 2005.....	5,000,000	--

The interest rate on borrowings under the 2002 Credit Facility may be fixed, at CNA Surety's option, for a period of one, two, three, or six months and is based on, among other rates, the London Interbank Offered Rate ("LIBOR"), plus the applicable margin. The margin, including a facility fee and utilization fee on the Revolving Credit Facility, was 1.30% at September 30, 2003 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 1.15% to 1.45%. The margin on the Term Loan, was 0.625% at September 30, 2003 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 0.48% to 0.80%. As of September 30, 2003, the weighted average interest rate was 2.7% on the \$50 million of outstanding borrowings. As of December 31, 2002, the weighted average interest rate on the 2002 Credit Facility was 2.0% on the \$60 million of outstanding borrowings.

The 2002 Credit Facility contains, among other conditions, limitations on CNA Surety with respect to the incurrence of additional indebtedness and maintenance of a rating of at least "A" by A.M. Best

Company Inc. for each of the Company's insurance subsidiaries. The 2002 Credit Facility also requires the maintenance of certain financial ratios as follows:  
a) maximum funded debt to total capitalization ratio of 25%, b) minimum net

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worth of \$350.0 million and c) minimum fixed charge coverage ratio of 2.5 times. At September 30, 2003 and December 31, 2002, CNA Surety was in compliance with all restrictive debt covenants, except for the fixed charge coverage ratio for the period ended September 30, 2003 for which CNA Surety obtained a waiver from the lenders. The lenders amended the 2002 Credit Facility to replace the fixed charge coverage ratio requirement for the next three quarters with a minimum earnings before interest, income taxes, depreciation and amortization requirement.

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 September 30, 2003 was \$0.4 million.

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

The dividends that may be paid without prior regulatory approval are determined by formulas established by the applicable insurance regulations, as described above. The formulas that determine dividend capacity in the current year are dependent on, among other items, the prior year's ending statutory surplus and statutory net income. Dividend capacity for 2003 is based on statutory surplus and income at and for the year ended December 31, 2002. Likewise, dividend capacity for 2004 will be based on the statutory earned surplus at December 31, 2003. Without prior regulatory approval in 2003, CNA Surety's insurance subsidiaries may pay stockholder dividends of \$32.1 million in the aggregate. CNA Surety received \$28.5 million and \$21.5 million in dividends from its insurance subsidiaries during the first nine months of 2003 and 2002, respectively.

Combined statutory surplus totaled \$161.2 million at September 30, 2003, resulting in a net written premium to statutory surplus ratio of 1.9 to 1. Approximately \$147 million of the combined surplus relates to Western Surety. Insurance regulations restrict Western Surety's maximum net retention on a single surety bond to 10 percent of statutory surplus. Under the 2003 Excess of Loss Treaty, the Company's net retention on new bonds would generally be \$15 million plus a 5% co-participation in the \$45 million layer of excess reinsurance above the Company's retention and this regulation would require minimum statutory surplus of \$172.5 million at Western Surety. Due to the decline in statutory surplus, effective October 1, 2003, pending state insurance department regulatory approval, the Company entered into a \$3 million excess of \$12 million surety excess of loss contract with CCC which lowers the Company's net retention on new bonds for the remainder of 2003 to \$12 million plus a 5% co-participation in the \$45

million layer of excess reinsurance with third party reinsurers. This surplus constraint may limit the amount of future dividends Western Surety could otherwise pay to CNA Surety.

In accordance with the provisions of intercompany tax sharing agreements between CNA Surety and its subsidiaries, the tax of each subsidiary shall be determined based upon each subsidiary's separate return liability. Intercompany tax payments are made at such times as estimated tax payments would be required by the Internal Revenue Service ("IRS"). CNA Surety received tax sharing payments from its subsidiaries of \$7.4 million for the nine months ended September 30, 2003 and \$9.9 million for the same period in 2002.

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

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

#### ITEM 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.

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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.

The Company's management has reviewed the circumstances that led to the restatement of results reflected in this report and concluded that this was an isolated incident and not indicative of a systemic failure of the controls over financial reporting.

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### CNA SURETY CORPORATION AND SUBSIDIARIES

#### PART II - OTHER INFORMATION

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

(a) Exhibits: -

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

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

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

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

(b) Reports on Form 8-K:

None

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#### 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

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John F. Welch  
President and Chief Executive Officer

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/s/ John F. Corcoran

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John F. Corcoran  
Senior Vice President and Chief Financial Officer

Date: March 12, 2004