

Flagstone Reinsurance Holdings Ltd
Form 10-Q
May 08, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

þ Quarterly Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2009

OR

o Transition Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission file number 001-33364

Flagstone Reinsurance Holdings Limited
(Exact Name of Registrant as Specified in Its Charter)

Bermuda
(State or Other Jurisdiction of
Incorporation or Organization)

98-0481623
(I.R.S. Employer
Identification No.)

Crawford House
23 Church Street
Hamilton HM 11
Bermuda
(Address of Principal Executive Offices)

(441) 278-4300
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Securities registered pursuant to Section 12(b) of the Act:
Common Shares, par value 1 cent per share
Name of exchange on which registered:
New York Stock Exchange
Bermuda Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
None

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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 a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of "accelerated filer", "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

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

As of April 30, 2009 the Registrant had 84,864,844 common voting shares outstanding, with a par value of \$0.01 per share.

FLAGSTONE REINSURANCE HOLDINGS LIMITED
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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

FLAGSTONE REINSURANCE HOLDINGS LIMITED
CONDENSED CONSOLIDATED BALANCE SHEETS
(Expressed in thousands of U.S. dollars, except share data)

| | As at March 31, 2009 (Unaudited) | As at December 31, 2008 |
|---|--|----------------------------|
| ASSETS | | |
| Investments: | | |
| Fixed maturities, at fair value (Amortized cost: 2009 - \$937,374 ; 2008 - \$787,792) | \$ 944,520 | \$ 784,355 |
| Short term investments, at fair value (Amortized cost: 2009 - \$121,347; 2008 - \$30,491) | 124,907 | 30,413 |
| Equity investments, at fair value (Cost: 2009 - \$10,698; 2008 - \$16,266) | 2,855 | 5,313 |
| Other investments | 52,314 | 54,655 |
| Total Investments | 1,124,596 | 874,736 |
| Cash and cash equivalents | 603,950 | 783,705 |
| Restricted cash | 41,644 | 42,403 |
| Premium balances receivable | 363,382 | 218,287 |
| Unearned premiums ceded | 68,014 | 31,119 |
| Reinsurance recoverable | 11,582 | 16,422 |
| Accrued interest receivable | 6,840 | 7,226 |
| Receivable for investments sold | 14,578 | 9,634 |
| Deferred acquisition costs | 59,970 | 44,601 |
| Funds withheld | 12,425 | 14,433 |
| Goodwill | 16,022 | 17,141 |
| Intangible assets | 32,531 | 32,873 |
| Other assets | 116,505 | 123,390 |
| Total Assets | \$ 2,472,039 | \$ 2,215,970 |
| LIABILITIES | | |
| Loss and loss adjustment expense reserves | \$ 429,802 | \$ 411,565 |
| Unearned premiums | 421,218 | 270,891 |
| Insurance and reinsurance balances payable | 51,641 | 31,123 |
| Payable for investments purchased | 28,762 | 7,776 |
| Long term debt | 265,306 | 252,575 |
| Other liabilities | 51,158 | 58,577 |
| Total Liabilities | 1,247,887 | 1,032,507 |
| EQUITY | | |
| Common voting shares, 150,000,000 authorized, \$0.01 par value, issued and outstanding | 849 | 848 |

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(2009 - 84,864,844; 2008 - 84,801,732)

| | | |
|---|--------------|--------------|
| Additional paid-in capital | 901,344 | 897,344 |
| Accumulated other comprehensive loss | (6,377) | (8,271) |
| Retained earnings | 128,307 | 96,092 |
| Total Flagstone Shareholders' Equity | 1,024,123 | 986,013 |
| Noncontrolling Interest in Subsidiaries | 200,029 | 197,450 |
| Total Equity | 1,224,152 | 1,183,463 |
| Total Liabilities and Equity | \$ 2,472,039 | \$ 2,215,970 |

The accompanying notes to the unaudited condensed consolidated financial statements are an integral part of the unaudited condensed consolidated financial statements.

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FLAGSTONE REINSURANCE HOLDINGS LIMITED
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
 AND COMPREHENSIVE INCOME

(Expressed in thousands of U.S. dollars, except share and per share data)

| | For the Three Months Ended | |
|---|----------------------------|------------------|
| | March 31, 2009 | March 31, 2008 |
| REVENUES | | |
| Gross premiums written | \$ 361,485 | \$ 242,246 |
| Premiums ceded | (75,669) | (16,014) |
| Net premiums written | 285,816 | 226,232 |
| Change in net unearned premiums | (112,981) | (90,975) |
| Net premiums earned | 172,835 | 135,257 |
| Net investment (loss) income | (1,753) | 18,696 |
| Net realized and unrealized losses - investments | (1,899) | (12,412) |
| Net realized and unrealized gains (losses) - other | 7,430 | (12,237) |
| Other income | 5,169 | 1,724 |
| Total revenues | 181,782 | 131,028 |
| EXPENSES | | |
| Loss and loss adjustment expenses | 76,594 | 39,767 |
| Acquisition costs | 28,037 | 24,165 |
| General and administrative expenses | 34,300 | 26,549 |
| Interest expense | 3,557 | 5,340 |
| Net foreign exchange losses (gains) | 1,097 | (6,699) |
| Total expenses | 143,585 | 89,122 |
| Income before income taxes and interest in earnings of equity investments | 38,197 | 41,906 |
| Provision for income tax | 706 | (865) |
| Interest in loss of equity investments | (378) | - |
| Net income | 38,525 | 41,041 |
| Less: Income attributable to noncontrolling interest | (2,782) | (8,181) |
| NET INCOME ATTRIBUTABLE TO FLAGSTONE | \$ 35,743 | \$ 32,860 |
| Net income | \$ 38,525 | \$ 41,041 |
| Change in currency translation adjustment | 1,867 | (1,420) |
| Change in defined benefit pension plan obligation | (176) | (549) |
| Comprehensive income | 40,216 | 39,072 |
| Less: Comprehensive income attributable to noncontrolling interest | (2,579) | (8,181) |
| COMPREHENSIVE INCOME ATTRIBUTABLE TO FLAGSTONE | \$ 37,637 | \$ 30,891 |
| Weighted average common shares outstanding—Basic | 85,070,002 | 85,469,270 |
| Weighted average common shares outstanding—Diluted | 85,208,295 | 85,690,742 |
| Net income attributable to Flagstone per common share—Basic | \$ 0.42 | \$ 0.38 |
| Net income attributable to Flagstone per common share—Diluted | \$ 0.42 | \$ 0.38 |

| | | | | |
|-------------------------------------|----|------|----|------|
| Dividends declared per common share | \$ | 0.04 | \$ | 0.04 |
|-------------------------------------|----|------|----|------|

The accompanying notes to the unaudited condensed consolidated financial statements are an integral part of the unaudited condensed consolidated financial statements.

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FLAGSTONE REINSURANCE HOLDINGS LIMITED
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY
 (Expressed in thousands of U.S. dollars, except share data)

| For the period ended March 31, 2009 | Total equity | Comprehensive income | Retained earnings | Accumulated other comprehensive loss | Common voting shares | Additional paid-in capital | Noncontrolling interest in subsidiaries |
|--|--------------|-------------------------|----------------------|---|----------------------------|----------------------------------|---|
| Beginning balance | \$ 1,183,463 | \$ - | \$ 96,092 | \$ (8,271) | \$ 848 | \$ 897,344 | \$ 197,450 |
| Comprehensive income: | | | | | | | |
| Net income | 38,525 | 38,525 | 35,743 | | | | 2,782 |
| Other comprehensive income: | | | | | | | |
| Change in currency translation adjustment | 1,867 | 1,867 | | 2,070 | | | (203) |
| Defined benefit pension plan obligation | (176) | (176) | | (176) | | | |
| | 1,691 | 1,691 | | | | | |
| Comprehensive income | 40,216 | \$ 40,216 | | | | | |
| Stock based compensation | 4,000 | | | | | 4,000 | |
| Subsidiary stock based compensation | | | | | | | |
| Issue of shares, net | 1 | | | | 1 | | |
| Dividends declared | (3,528) | | (3,528) | | | | |
| Ending balance | \$ 1,224,152 | | \$ 128,307 | \$ (6,377) | \$ 849 | \$ 901,344 | \$ 200,029 |
| For the period ended March 31, 2008 | Total equity | Comprehensive income | Retained earnings | Accumulated other comprehensive income | Common voting shares | Additional paid-in capital | Noncontrolling interest in subsidiaries |
| Beginning balance | \$ 1,395,263 | \$ - | \$ 296,890 | \$ 7,426 | \$ 853 | \$ 905,316 | \$ 184,778 |

| | | | | | | | | |
|---|--------------|-----------|------------|----------|--------|------------|-------|------------|
| Repurchase of preferred shares | (6,639) | | | | | | | (6,639) |
| Comprehensive income: | | | | | | | | |
| Net income | 41,041 | 41,041 | 32,860 | | | | | 8,181 |
| Other comprehensive income: | | | | | | | | |
| Change in currency translation adjustment | (1,420) | (1,420) | | | | (1,420) | | |
| Defined benefit pension plan obligation | (549) | (549) | | | | (549) | | |
| | (1,969) | (1,969) | | | | | | |
| Comprehensive income | 39,072 | \$ 39,072 | | | | | | |
| Stock based compensation | 3,710 | | | | | | 3,710 | |
| Subsidiary stock based compensation | (131) | | | | | | | (131) |
| Issue of shares, net | - | | | | | | | |
| Dividends declared | (3,524) | | (3,524) | | | | | |
| Other | (91) | | | | | | | (91) |
| Ending balance | \$ 1,427,660 | | \$ 326,226 | \$ 5,457 | \$ 853 | \$ 909,026 | | \$ 186,098 |

The accompanying notes to the unaudited condensed consolidated financial statements are an integral part of the unaudited condensed consolidated financial statements.

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FLAGSTONE REINSURANCE HOLDINGS LIMITED
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (Expressed in thousands of U.S. dollars)

| | For the Three Months Ended | |
|---|----------------------------|----------------|
| | March 31, 2009 | March 31, 2008 |
| Cash flows provided by (used in) operating activities: | | |
| Net income | \$ 38,525 | \$ 41,041 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net realized and unrealized (gains) losses | (5,531) | 24,649 |
| Net unrealized foreign exchange gains | (3,824) | - |
| Depreciation expense | 1,616 | 1,154 |
| Share based compensation expense | 3,873 | 3,599 |
| Interest in earnings of equity investments | 378 | - |
| Accretion/amortization on fixed maturities | 8,727 | (4,754) |
| Changes in assets and liabilities, excluding net assets acquired: | | |
| Reinsurance premium receivable | (145,763) | (66,304) |
| Unearned premiums ceded | (36,864) | (3,475) |
| Deferred acquisition costs | (15,947) | (6,237) |
| Funds withheld | 1,969 | (3,696) |
| Loss and loss adjustment expense reserves | 24,161 | 18,257 |
| Unearned premiums | 152,944 | 98,123 |
| Insurance and reinsurance balances payable | 20,708 | (287) |
| Resinsurance recoverable | 5,306 | - |
| Other changes in assets and liabilities, net | 22,867 | 3,726 |
| Net cash provided by operating activities | 73,145 | 105,796 |
| Cash flows (used in) provided by investing activities: | | |
| Purchases of fixed income securities | (735,207) | (399,242) |
| Sales and maturities of fixed income securities | 509,347 | 732,348 |
| Purchases of equity securities | (2,006) | (20,131) |
| Sales of equity securities | 4,177 | - |
| Purchases of other investments | (46) | (2,002) |
| Sales of other investments | (12,480) | (51,885) |
| Purchases of fixed assets | (3,813) | (4,830) |
| Sale of fixed asset | 145 | - |
| Change in restricted cash | 759 | (250) |
| Net cash (used in) provided by investing activities | (239,124) | 254,008 |
| Cash flows (used in) provided by financing activities: | | |
| Contribution of minority interest | - | (222) |
| Repurchase of minority interest | - | (6,639) |
| Dividend paid on common shares | (3,392) | (3,413) |
| Repayment of long term debt | (749) | - |
| Other | 207 | 205 |
| Net cash used in financing activities | (3,934) | (10,069) |

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| | | |
|--|------------|------------|
| Effect of foreign exchange rate on cash | (9,842) | (1,904) |
| (Decrease) increase in cash and cash equivalents | (179,755) | 347,831 |
| Cash and cash equivalents - beginning of year | 783,705 | 362,622 |
| Cash and cash equivalents - end of period | \$ 603,950 | \$ 710,453 |
| Supplemental cash flow information: | | |
| Receivable for investments sold | \$ 14,578 | \$ 5,660 |
| Payable for investments purchased | \$ 28,762 | \$ 23,843 |
| Interest paid | \$ 3,762 | \$ 5,588 |

The accompanying notes to the unaudited condensed consolidated financial statements are an integral part of the unaudited condensed consolidated financial statements.

FLAGSTONE REINSURANCE HOLDINGS LIMITED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Amounts in tables expressed in thousands of U.S. dollars, except for ratios, share and per share amounts)

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1. Basis of Presentation and Consolidation

These unaudited condensed consolidated financial statements include the accounts of Flagstone Reinsurance Holdings Limited (the “Company”) and its wholly owned subsidiaries, including Flagstone Réassurance Suisse SA (“Flagstone Suisse”) and have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These unaudited condensed consolidated financial statements include the accounts of the Company and its subsidiaries, including those that meet the consolidation requirements of variable interest entities (“VIEs”). The Company assesses the consolidation of VIEs based on whether the Company is the primary beneficiary of the entity in accordance with Financial Accounting Standards Board (“FASB”) Interpretation No. 46, as revised, “Consolidation of Variable Interest Entities - an interpretation of ARB No. 51” (“FIN 46(R)"). Entities in which the Company has an ownership of more than 20% and less than 50% of the voting shares are accounted for using the equity method. All inter-company accounts and transactions have been eliminated on consolidation.

The preparation of these unaudited condensed consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported disclosed amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Company's principal estimates are for loss and loss adjustment expenses, estimates of premiums written, premiums earned, acquisition costs and share based compensation. The Company reviews and revises these estimates as appropriate based on current information. Any adjustments made to these estimates are reflected in the period the estimates are revised.

In the opinion of management, these unaudited condensed consolidated financial statements reflect all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the Company's financial position and results of operations as at the end of and for the periods presented. The results of operations and cash flows for any interim period will not necessarily be indicative of the results of operations and cash flows for the full fiscal year or subsequent quarters. This Quarterly Report on Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2008 filed with the Securities and Exchange Commission (the “SEC”) on March 13, 2009.

These interim financial statements separately present restricted cash and reinsurance recoverable. In the prior period these amounts were included with cash and cash equivalents and other assets. This presentation of of prior period amounts is consistent with the current period presentation with no effect on net income or loss attributable to Flagstone

2. New Accounting Pronouncements

Adoption of new accounting pronouncements

On January 1, 2009, the Company adopted the provisions of the FASB Statement No. 160, “Noncontrolling Interests in Consolidated Financial Statements – an amendment of Accounting Research Bulletin No. 51” (“SFAS 160”). SFAS 160

requires all entities to report noncontrolling interests in subsidiaries (formerly known as minority interests) as a separate component of equity in the consolidated balance sheets, to clearly identify consolidated net income attributable to the parent and to the noncontrolling interest on the face of the consolidated statement of operations, and to provide sufficient disclosure that clearly identifies and distinguishes between the interest of the parent and the interests of noncontrolling owners. SFAS 160 also establishes accounting and reporting standards for changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. The effect of adopting this Statement was immaterial to our financial statements.

On January 1, 2009, the Company adopted the provisions of FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133 ("SFAS 161"). The provisions of SFAS 161 amend and expand the disclosure requirements for derivative instruments and hedging activities by requiring enhanced disclosures about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedged items are accounted for under FASB Statement No. 133 "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"), and its related interpretations, and (iii) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The effect of adopting this Statement was immaterial to our financial statements.

New accounting pronouncements issued during 2009 impacting the Company are as follows:

On April 9, 2009, the FASB issued three FASB staff positions ("FSP") intended to provide additional application guidance and enhance disclosures regarding fair value measurements and impairments of securities: FSP FAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly" ("FSP FAS 157-4"), FSP FAS 107-1 and APB 28-1, "Interim Disclosures about Fair Value of Financial Instruments" ("FSP FAS 107-1 and APB 28-1") and FSP FAS 115-2 and FAS 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments" ("FSP FAS 115-2 and FSP FAS 124-2").

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FSP FAS 157-4 provides guidelines for making fair value measurements more consistent with the principles presented in FASB Statement No. 157, "Fair Value Measurements" ("SFAS 157"). FSP FAS 157-4 relates to determining fair values when there is no active market or where the price inputs being used represent distressed sales. It reaffirms what SFAS 157 states is the objective of fair value measurement—to reflect how much an asset would be sold for in an orderly transaction (as opposed to a distressed or forced transaction) at the date of the financial statements under current market conditions. Specifically, it reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive.

FSP FAS 107-1 and APB 28-1 enhance consistency in financial reporting by increasing the frequency of fair value disclosures. The guidance relates to fair value disclosures for any financial instruments that are not currently reflected on the balance sheet of companies at fair value. Prior to issuing this FSP, fair values for these assets and liabilities were only disclosed once a year. The FSP now requires these disclosures on a quarterly basis, providing qualitative and quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value.

FSP FAS 115-2 and FSP FAS 124-2 provide additional guidance designed to create greater clarity and consistency in accounting for and presenting impairment losses on securities. The guidance is intended to bring greater consistency to the timing of impairment recognition, and provide greater clarity to investors about the credit and noncredit components of impaired debt securities that are not expected to be sold. The measure of impairment in comprehensive income remains fair value. The FSP also requires increased and more timely disclosures sought by investors regarding expected cash flows, credit losses, and an aging of securities with unrealized losses.

These FSPs are effective for interim and annual periods ending after June 15, 2009. The Company has considered the provisions of these FSPs and determined that their application will not have a material effect on the Company's financial position when adopted.

3. Investments

Fair value disclosure

In accordance with SFAS 157, the Company determined that its investments in U.S. government securities, listed equity securities and fixed income fund are stated at Level 1 fair value as determined by the quoted market price of these securities, as provided either by independent pricing services or exchange market prices. Investments in corporate bonds, mortgage-backed securities, asset-backed securities, exchange traded funds, investment funds that are hedge funds, real estate investment trusts ("REITs") and REIT funds are stated at Level 2 fair value derived from broker quotes based on inputs that are observable for the asset, either directly or indirectly, such as yield curves and transactional history. There are two mortgage-backed securities that were classified as Level 3 due to the limited availability of the pricing sources. The Company has reviewed its Level 3 investments, and the valuation methods are as follows: Catastrophe bonds are stated at fair value as determined by reference to broker indications. Those indications are based on current market conditions, including liquidity and transactional history, recent issue price of similar catastrophe bonds and seasonality of the underlying risks. The private equity investments are valued by the investment fund managers using the valuations and financial statements provided by the general partners of the funds on a quarterly basis. These valuations are then adjusted by the investment fund managers for cash flows since the

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most recent valuation. The valuation methodology used for the investment funds is consistent with the methodology that is generally employed in the investment industry. The valuation technique used to fair value the financial instruments is the market approach which uses prices and other relevant information generated by market transactions involving identical or comparable assets. When the market for a security is considered active and multiple quotes are obtained with identical prices, the quote is considered to be binding.

As at March 31, 2009 and December 31, 2008, the Company's investments are allocated between levels as follows:

| Description | Fair Value Measurements | Fair Value Measurement at March 31, 2009, using: | | |
|----------------------------|-------------------------|--|---|---|
| | | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
| Fixed maturity investments | \$ 944,520 | \$ 443,362 | \$ 500,200 | \$ 958 |
| Short term investments | 124,907 | - | 124,907 | - |
| Equity investments | 2,855 | 2,855 | - | - |
| | 1,072,282 | 446,217 | 625,107 | 958 |
| Other Investments | | | | |
| Investment funds | 7,841 | - | - | 7,841 |
| Catastrophe bonds | 39,175 | - | - | 39,175 |
| | 47,016 | - | - | 47,016 |
| Totals | \$ 1,119,298 | \$ 446,217 | \$ 625,107 | \$ 47,974 |

For reconciliation purposes, the table above does not include an equity investment of \$5.3 million in which the Company is deemed to have a significant influence and is accounted for under the equity method and as such, is not accounted for at fair value under SFAS 159, "The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115" ("SFAS 159").

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(Amounts in tables expressed in thousands of U.S. dollars, except for ratios, share and per share amounts)

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The total change in fair value of the Level 3 items still held as of March 31, 2009 is \$(1.3) million.

| Description | Fair Value Measurement at December 31, 2008, using: | | | |
|----------------------------|---|---|---|--|
| | Fair Value Measurements | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
| Fixed maturity investments | \$ 784,355 | \$ 447,226 | \$ 336,203 | \$ 926 |
| Short term investments | 30,413 | 30,413 | - | - |
| Equity investments | 5,313 | 5,313 | - | - |
| | 820,081 | 482,952 | 336,203 | 926 |
| Other Investments | | | | |
| Investment funds | 9,805 | - | 647 | 9,158 |
| Catastrophe bonds | 39,174 | - | - | 39,174 |
| | 48,979 | - | 647 | 48,332 |
| Totals | \$ 869,060 | \$ 482,952 | \$ 336,850 | \$ 49,258 |

For reconciliation purposes, the table above does not include an equity investment of \$5.7 million in which the Company is deemed to have a significant influence and is accounted for under the equity method and as such, is not accounted for at fair value under SFAS 159.

The reconciliation of the fair value for the Level 3 investments for the three months ended March 31, 2009, including net purchases and sales and change in unrealized gains, is set out below:

| Description | For the Three Months Ended March 31, 2009 |
|--|--|
| Fair value, December 31, 2008 | \$ 49,258 |
| Total unrealized losses included in earnings | (1,260) |
| Net purchases and sales | 54 |
| Total investment income included in earnings | (78) |
| Fair value, March 31, 2009 | \$ 47,974 |

Pledged assets

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As at March 31, 2009 and December 31, 2008, approximately \$41.6 million and \$42.4 million, respectively, of cash and cash equivalents and approximately \$360.5 million and \$327.2 million, respectively, of fixed maturity securities were deposited or pledged in favor of ceding companies and other counterparties or government authorities to comply with reinsurance contract provisions and insurance laws.

FLAGSTONE REINSURANCE HOLDINGS LIMITED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Amounts in tables expressed in thousands of U.S. dollars, except for ratios, share and per share amounts)

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4. Derivatives

The Company accounts for its derivative instruments using SFAS No. 133, which requires an entity to recognize all derivative instruments as either assets or liabilities in the balance sheet and measure those instruments at fair value, with the fair value recorded in other assets or liabilities. The accounting for realized and unrealized gains and losses associated with changes in the fair value of derivatives depends on its hedge designation and whether the hedge is highly effective in achieving offsetting changes in the fair value of the asset or liability being hedged. The realized and unrealized gains and losses on derivatives not designated as hedging instruments are included in net realized and unrealized gains and losses in the consolidated financial statements. Gains and losses associated with changes in fair value of the designated hedge instruments are recorded with the gains and losses on the hedged items, to the extent that the hedge is effective.

The details of the derivatives held by the Company as of March 31, 2009 and December 31, 2008 are as follows:

| As at March 31, 2009 | | | | | | | | |
|---|--------------|------------|------------|-----------------------|----------|------------|-------------------|------------|
| Asset Derivatives | | | | Liability Derivatives | | | Total Derivatives | |
| Balance | | Derivative | | Balance | | Derivative | | Net |
| Sheet | Location | Exposure | Fair Value | Sheet | Location | Exposure | Fair Value | Fair Value |
| Derivatives designated as hedging instruments | | | | | | | | |
| Forward currency forward contracts (1) | | | | | | | | |
| Other Assets | | \$ 41,108 | \$ 214 | Other Liabilities | | \$ 140,706 | \$ 627 | \$ (413) |
| | | | 214 | | | | 627 | (413) |
| Derivatives not designated as hedging instruments | | | | | | | | |
| Futures contracts | Other Assets | \$ 44,578 | \$ 2,981 | Other Liabilities | | \$ - | \$ - | \$ 44,578 |
| | | | | | | | | \$ 2,981 |
| Total return swaps | Other Assets | 48,000 | 1,620 | Other Liabilities | | - | - | 48,000 |
| | | | | | | | | 1,620 |
| Currency swaps | Other Assets | - | - | Other Liabilities | | 17,272 | 1,124 | (1,124) |
| | | | | | | | | |
| Forward currency forward contracts | Other Assets | 166,975 | 5,881 | Other Liabilities | | 345,362 | 10,080 | (4,199) |
| | | | | | | | | |

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| | | | | | | | | |
|--------------------------------|--------------|--------|-----------|-------------------|---|-----------|--------|------------|
| Mortgage backed securities TBA | Other Assets | 44,249 | 445 | Other Liabilities | - | - | 44,249 | 445 |
| Other reinsurance derivatives | Other Assets | - | - | Other Liabilities | - | 1,355 | - | (1,355) |
| | | | 10,927 | | | 12,559 | | (1,632) |
| Total Derivatives | | | \$ 11,141 | | | \$ 13,186 | | \$ (2,045) |

(1) Recognized as a foreign currency hedge under SFAS 133.

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As at December 31, 2008

| | Asset Derivatives | | | Liability Derivatives | | | Total Derivatives | |
|---|-------------------|---------------------|-----------------|-----------------------|---------------------|------------------|---------------------|-------------------|
| | Balance Sheet | Derivative Exposure | Fair Value | Balance Sheet | Derivative Exposure | Fair Value | Derivative Exposure | Net Fair Value |
| Derivatives designated as hedging instruments | | | | | | | | |
| Forward currency forward contracts (1) | Other Assets | \$ 43,327 | \$ 1,419 | Other Liabilities | \$ 294,385 | \$ 7,103 | \$ 337,712 | \$ (5,684) |
| | | | 1,419 | | | 7,103 | | (5,684) |
| Derivatives not designated as hedging instruments | | | | | | | | |
| Futures contracts | Other Assets | \$ 40,530 | \$ 333 | Other Liabilities | \$ 21,356 | \$ 190 | \$ 61,886 | \$ 143 |
| Total return swaps | Other Assets | 58,395 | 5,564 | Other Liabilities | 12,473 | 1,852 | 70,868 | 3,712 |
| Currency swaps | Other Assets | - | - | Other Liabilities | 18,071 | 315 | 18,071 | (315) |
| Forward currency forward contracts | Other Assets | 54,768 | 1,493 | Other Liabilities | 60,924 | 5,317 | 115,692 | (3,824) |
| Mortgage backed securities TBA | Other Assets | 63,937 | 648 | Other Liabilities | - | - | 63,937 | 648 |
| Other reinsurance derivatives | Other Assets | - | - | Other Liabilities | - | 541 | - | (541) |
| | | | 8,038 | | | 8,215 | | (177) |
| Total Derivatives | | | \$ 9,457 | | | \$ 15,318 | | \$ (5,861) |

(1) Recognized as a foreign currency hedge under SFAS 133.

Designated

Amount of Gain or (Loss) on Derivatives Recognized in

| Derivatives Designated as Hedging Instruments | Comprehensive Income (Loss) (Effective Portion) For the Three Months Ended | | Location | Income Statement (Ineffective Portion) For the Three Months Ended | |
|--|--|-------------------|----------|---|---|
| | March 31, 2009 | March 31, 2008 | | March 31, 2009 | March 31, 2008 |
| | | | | | Net realized and unrealized (losses) gains - other |
| Forward currency forward contracts (1) | \$ 6,795 | \$ (29,854) | | \$ (582) | \$ 843 |
| | \$ 6,795 | \$ (29,854) | | \$ (582) | \$ 843 |

(1) Recognized as a foreign currency hedge under SFAS 133.

Foreign currency forward contracts

The Company has entered into certain foreign currency forward contracts that it has designated as hedges in order to hedge its net investments in foreign subsidiaries. These foreign currency forward contracts are carried at fair value and the gains and losses associated with changes in fair value of the designated hedge instruments are recorded in other comprehensive income as part of the cumulative translation adjustment, to the extent that these are effective as hedges. All other derivatives are not designated as hedges, and accordingly, these instruments are carried at fair value, with the fair value recorded in other assets or liabilities with the corresponding realized and unrealized gains and losses included in net realized and unrealized gains and losses.

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Non Designated

Gain or (Loss) on Derivatives Recognized in Income Statement

| Derivatives Not Designated as Hedging Instruments | Location | For the Three Months Ended | |
|--|---|----------------------------|----------------|
| | | March 31, 2009 | March 31, 2008 |
| Futures contracts | Net realized and unrealized (losses) gains - investments | \$ (4,153) | \$ (20,071) |
| Total return swaps | Net realized and unrealized (losses) gains - investments | (8,735) | (347) |
| Currency swaps | Net realized and unrealized (losses) gains - other | (785) | 1,803 |
| Interest rate swaps | Net realized and unrealized (losses) gains - investments | - | 1,793 |
| Interest rate swaps | Net realized and unrealized (losses) gains - other | - | (9,194) |
| Forward currency forward contracts | Net realized and unrealized (losses) gains - investments | (3,166) | - |
| Forward currency forward contracts | Net realized and unrealized (losses) gains - other | 8,257 | (6,402) |
| Mortgage backed securities TBA | Net realized and unrealized (losses) gains - investments | 958 | 442 |
| Other reinsurance derivatives | Net realized and unrealized (losses) gains - other | 540 | 714 |
| | | \$ (7,084) | \$ (31,262) |

The non-designated derivatives are carried at fair value, with the fair value recorded in other assets or liabilities with the corresponding realized and unrealized gains and losses included in net realized and unrealized gains and losses.

Futures contracts

The Company has used futures contracts to gain exposure to certain markets or indexes. The Company has entered into equity index, commodity index and bond index futures as part of its portfolio strategy.

Total return swaps

The Company uses total return swaps to gain exposure to the U.S. real estate market. The total return swaps allow the Company to earn the return of the underlying index while paying floating interest plus a spread to the counterparty.

Foreign currency swaps

The Company periodically uses foreign currency swaps to minimize the effect of fluctuating foreign currencies. The foreign currency swaps relate to the Company's Euro denominated debentures.

Foreign currency forwards

The Company and its subsidiaries use foreign currency forward contracts to manage currency exposures related to balance sheet and income statement balances.

To be announced mortgage backed securities

The Company also purchases "to be announced" mortgage-backed securities ("TBAs") as part of its investing activities. By acquiring a TBA, the Company makes a commitment to purchase a future issuance of mortgage-backed securities.

Other reinsurance derivatives

The Company writes certain reinsurance contracts that are classified as derivatives under SFAS 133. The Company has entered into industry loss warranty ("ILW") transactions that may be structured as reinsurance or derivatives.

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Fair value disclosure

In accordance with SFAS 157, the fair value of derivative instruments held as of March 31, 2009 and December 31, 2008 is allocated between levels as follows:

| | Fair Value Measurement at March 31, 2009, using: | | | |
|---------------------------------------|--|---|--|--|
| | Fair Value Measurements | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
| Derivatives | | | | |
| Futures contracts | \$ 2,981 | \$ 2,981 | \$ - | \$ - |
| Swaps | 496 | - | 496 | - |
| Forward currency forward contracts | (4,612) | - | (4,612) | - |
| Mortgage backed securities TBA | 445 | - | 445 | - |
| Other reinsurance derivatives | (1,355) | - | - | (1,355) |
| Total derivatives | \$ (2,045) | \$ 2,981 | \$ (3,671) | \$ (1,355) |

The total change in fair value of the Level 3 items still held as of March 31, 2009 is \$(1.4) million.

| | Fair Value Measurement at December 31, 2008, using: | | | |
|---------------------------------------|---|---|---|--|
| | Fair Value Measurements | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
| Derivatives | | | | |
| Futures contracts | \$ 143 | \$ 143 | \$ - | \$ - |
| Swaps | 3,397 | - | 3,397 | - |
| Forward currency forward contracts | (9,508) | - | (9,508) | - |
| Mortgage backed securities TBA | 648 | - | 648 | - |
| Other reinsurance derivatives | (541) | - | - | (541) |
| Total derivatives | \$ (5,861) | \$ 143 | \$ (5,463) | \$ (541) |

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The reconciliation of the fair value for the Level 3 derivative instruments, including net purchases and sales, realized gains and changes in unrealized gains, is as follows:

| | Three Months Ended March 31, 2009 | |
|---|---|---------|
| Other reinsurance derivatives | | |
| Opening fair value, December 31, 2008 | \$ | (541) |
| Total premium earned included in earnings | | 540 |
| Net purchases and sales | | (1,354) |
| Fair value, March 31, 2009 | \$ | (1,355) |

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5. Acquisition

Flagstone Alliance

During the first quarter of 2009, the Company finalized the allocation of the purchase price for the acquisition of Flagstone Alliance Insurance & Reinsurance PLC (“Flagstone Alliance”). At December 31, 2008 the estimated purchase price allocation included \$1.1 million of goodwill, which has been reduced to \$nil at March 31, 2009.

| | As at October 1, 2008 |
|--|-----------------------------|
| Total purchase price | \$ 45,302 |
| Assets acquired | |
| Cash and cash equivalents | \$ 40,066 |
| Investments | 22,488 |
| Reinsurance premium balances receivable | 41,916 |
| Unearned premiums ceded | 2,548 |
| Reinsurance recoverable | 9,298 |
| Deferred acquisition costs | 7,930 |
| Fixed assets | 31,247 |
| Intangible asset - indefinite useful life | 1,056 |
| Other assets | 1,611 |
| Assets acquired | 158,160 |
| Liabilities acquired | |
| Loss reserves | 61,032 |
| Unearned premiums | 34,404 |
| Insurance and reinsurance balances payable | 14,908 |
| Other liabilities | 2,514 |
| Liabilities acquired | 112,858 |
| Excess purchase price (Goodwill) | \$ - |

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6. Goodwill and Intangibles

| | Carrying value at December 31, 2008 | Accumulated amortization (1) | Impact of foreign exchange | Carrying value at March 31, 2009 |
|-----------------------------|--|------------------------------------|----------------------------------|---|
| Finite life intangibles | | | | |
| Tradename | \$ 1,294 | \$ (32) | \$ (3) | \$ 1,259 |
| Software | 3,882 | (97) | (8) | 3,777 |
| Distribution network | 3,306 | (82) | (6) | 3,218 |
| | \$ 8,482 | \$ (211) | \$ (17) | \$ 8,254 |
| Indefinite life intangibles | | | | |
| Lloyd's syndicate capacity | \$ 22,573 | \$ - | \$ (46) | \$ 22,527 |
| Licenses | 1,818 | - | (68) | 1,750 |
| | \$ 24,391 | \$ - | \$ (114) | \$ 24,277 |

Aggregate amortization expenses (1)

| | |
|-------------------------------------|--------|
| For the period ended March 31, 2009 | \$ 209 |
|-------------------------------------|--------|

| | For the year ended December 31 | Amount |
|--------------------------------|---|--------|
| Estimated amortization expense | 2009 | \$ 834 |
| | 2010 | \$ 804 |
| | 2011 | \$ 776 |
| | 2012 | \$ 751 |
| | 2013 | \$ 729 |

Goodwill relates to the following reportable segments:

| | Reinsurance | Lloyd's | Insurance | Unallocated | Total |
|-------------------------------------|-------------|----------|-----------|-------------|-----------|
| Balance as at December 31, 2008 | \$ 4,118 | \$ - | \$ 10,050 | \$ 2,973 | \$ 17,141 |
| Allocated to Lloyd's segment | - | 2,973 | - | (2,973) | - |
| Purchase price allocation finalized | (1,043) | - | - | - | (1,043) |
| Impact of foreign exchange | (69) | (7) | - | - | (76) |
| Balance at end of period | \$ 3,006 | \$ 2,966 | \$ 10,050 | \$ - | \$ 16,022 |

(1) Accumulated amortization is converted at the end of period foreign exchange rate and amortization expense is converted at an average foreign exchange rate for the period.

7. Debt and Financing Arrangements

Long term debt

Interest expense includes interest payable and amortization of debt offering expenses. The debt offering expenses are amortized over the period from the issuance of the Deferrable Interest Debentures to the earliest date that they may be called by the Company. For the three months ended March 31, 2009 and 2008, the Company incurred interest expense of \$3.6 million and \$5.3 million, respectively, on the Deferrable Interest Debentures. Also, at March 31, 2009 and December 31, 2008, the Company had \$1.0 million and \$1.4 million, respectively, of interest payable included in other liabilities.

Letter of credit facilities

On March 5, 2009, Flagstone Suisse entered into a \$200.0 million secured committed letter of credit facility with Barclays Bank Plc (the "Facility"). The Facility will be used to support the reinsurance obligations of the Company and its subsidiaries. As at March 31, 2009, no letters of credit have been issued under this facility.

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On January 22, 2009, Flagstone Suisse entered into a secured \$450.0 million standby letter of credit facility with Citibank Europe Plc (the "Facility"). The Facility comprises a \$300.0 million facility for letters of credit with a maximum tenor of 15 months and a \$150.0 million facility for letters of credit issued in respect of Funds at Lloyds with a maximum tenor of 60 months, in each case subject to automatic extension for successive periods, but in no event longer than one year. The Facility will be used to support the reinsurance obligations of the Company and its subsidiaries. As at March 31, 2009, \$324.5 million had been drawn under this facility, and the drawn amount of the facility was secured by \$360.5 million of fixed maturity securities from the Company's investment portfolio. During 2008, the Company had a \$400.0 million uncommitted letter of credit facility agreement with Citibank N.A. As at December 31, 2008, \$285.7 million had been drawn under this facility, and the drawn amount of the facility was secured by \$327.2 million of fixed maturity securities from the Company's investment portfolio. This facility was replaced by the above noted \$450.0 million facility.

In September 2007, the Company entered into a \$200.0 million uncommitted letter of credit facility agreement with Wachovia Bank, N.A. ("Wachovia"). Flagstone Reinsurance Limited had not drawn upon this facility as at March 31, 2009. Wachovia and the Company are currently engaged in negotiations to potentially amend or revise the facility to accommodate the restructuring of the Company's global reinsurance operations which occurred on September 30, 2008.

These facilities are used to provide security to reinsureds and are collateralized by the Company, at least to the extent of the letters of credit outstanding at any given time.

8. Share Based Compensation

The Company accounts for share based compensation in accordance with SFAS No. 123(R), "Share Based Payments" ("SFAS 123(R)"), which requires entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. The cost of such services will be recognized over the period during which an employee is required to provide service in exchange for the award.

Performance Share Units

The Performance Share Unit Plan ("PSU Plan") is the Company's shareholder approved primary executive long-term incentive scheme. Pursuant to the terms of the PSU Plan, at the discretion of the Compensation Committee of the Board of Directors, Performance Share Units ("PSUs") may be granted to executive officers and certain other key employees and vesting is contingent upon the Company meeting certain diluted return-on-equity ("DROE") goals.

A summary of the activity under the PSU Plan as at March 31, 2009, and changes during the three months ended March 31, 2009, is as follows:

| Three Months Ended March 31, 2009 | | |
|-----------------------------------|----------|----------|
| Number | Weighted | Weighted |
| expected to | average | average |

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| | vest | grant date fair value | remaining contractual term |
|----------------------------------|-----------|--------------------------|----------------------------------|
| Outstanding at beginning of year | 2,189,982 | \$ 10.13 | 2.5 |
| Granted | 818,000 | \$ 9.77 | |
| Forfeited | (76,279) | \$ 10.24 | |
| Exercised in the period | (60,000) | \$ 10.25 | |
| Outstanding at end of period | 2,871,703 | \$ 10.02 | 2.4 |

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The Company reviews its assumptions in relation to the PSUs on a quarterly basis. For the periods ended March 31, 2009 and 2008, respectively, \$2.7 million and \$2.2 million of compensation expense has been recorded in general and administrative expenses in relation to the PSU Plan. The issuance of shares with respect to the PSUs is contingent upon the attainment of certain levels of average DROE over a two or three year period. As at March 31, 2009 and December 31, 2008, there was a total of \$25.5 million and \$21.0 million, respectively, of unrecognized compensation cost related to non-vested PSUs; that cost is expected to be recognized over a period of approximately 2.4 years and 2.5 years, respectively.

Since the inception of the PSU Plan, 60,000 PSUs have vested and been exercised and 2,368,658 PSUs have been cancelled.

Restricted Share Units

Beginning July 1, 2006, the Company granted Restricted Share Units (“RSUs”) to certain employees and directors of the Company. The purpose of the Restricted Share Unit Plan (“RSU Plan”) is to encourage employees and directors of the Company to further the development of the Company and to attract and retain key employees for the Company’s long-term success. The RSUs granted to employees vest over a period of approximately two years while RSUs granted to directors vest on the grant date.

A summary of the activity under the RSU Plan as at March 31, 2009, and changes during the three months ended March 31, 2009, is as follows:

| | Three Months Ended March 31, 2009 | | |
|----------------------------------|-----------------------------------|---|---|
| | Number expected to vest | Weighted average grant date fair value | Weighted average remaining contractual term |
| Outstanding at beginning of year | 282,876 | \$ 13.13 | 0.5 |
| Granted | 254,481 | \$ 9.77 | |
| Forfeited | (9,005) | \$ 10.69 | |
| Exercised in the period | (2,985) | \$ 13.90 | |
| Outstanding at end of period | 525,367 | \$ 11.54 | 0.8 |

As at March 31, 2009 and December 31, 2008, there was a total of \$2.3 million and \$1.0 million, respectively, of unrecognized compensation cost related to non-vested RSUs; that cost is expected to be recognized over a period of approximately 1.3 years and 1.0 year, respectively. A compensation expense of \$1.2 million and \$1.4 million has been recorded in general and administrative expenses for the three months ended March 31, 2009 and 2008, respectively, in relation to the RSU Plan.

Since the inception of the RSU Plan in July 2006, 230,296 RSUs granted to employees have vested and no RSUs granted to employees have been cancelled. During the three months ended March 31, 2009 and 2008, 72,666 and 55,715 RSUs, respectively, were granted to the directors. During the three months ended March 31, 2009 and 2008, 2,985 and 7,817 RSUs, respectively, granted to directors were converted into common shares of the Company as elected by the directors.

The company uses a nil forfeiture assumption for its PSUs and RSUs. The intrinsic value of the PSUs and RSUs outstanding as of March 31, 2009 was \$22.4 million and \$4.1 million, respectively.

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9. Earnings Per Common Share

The computation of basic and diluted earnings per common share for the three months ended March 31, 2009 and 2008 is as follows:

| | Three Months Ended | |
|--|--------------------|----------------|
| | March 31, 2009 | March 31, 2008 |
| Basic earnings per common share | | |
| Net income attributable to Flagstone | \$ 35,743 | \$ 32,860 |
| Weighted average common shares outstanding | 84,862,556 | 85,311,942 |
| Weighted average vested restricted share units | 207,446 | 157,328 |
| Weighted average common shares outstanding—Basic | 85,070,002 | 85,469,270 |
| Basic earnings per common share | \$ 0.42 | \$ 0.38 |
| Diluted earnings per common share | | |
| Net income attributable to Flagstone | \$ 35,743 | \$ 32,860 |
| Weighted average common shares outstanding | 84,862,556 | 85,311,942 |
| Weighted average vested restricted share units outstanding | 207,446 | 157,328 |
| | 85,070,002 | 85,469,270 |
| Share equivalents: | | |
| Weighted average unvested restricted share units | 138,293 | 221,472 |
| Weighted average common shares outstanding—Diluted | 85,208,295 | 85,690,742 |
| Diluted earnings per common share | \$ 0.42 | \$ 0.38 |

At March 31, 2009 and 2008, there was a warrant outstanding which would result in the issuance of 8,585,747 common shares that were excluded from the computation of diluted earnings per common share because the effect would be anti-dilutive. Because the number of shares contingently issuable under the PSU Plan depends on the average DROE over a two or three year period, the PSUs are excluded from the calculation of diluted earnings per common share until the end of the performance period, at which time the number of shares issuable under the PSU Plan will be known. As at March 31, 2009, and 2008, there were 2,871,703 and 2,308,658 PSUs outstanding, respectively. The maximum number of common shares that could be issued under the PSU Plan at March 31, 2009 and 2008 was 4,307,555 and 4,617,316, respectively.

10. Common Shares

| | For the Three Months Ended | |
|------------------------------|----------------------------|-------------------|
| | March 31, 2009 | December 31, 2008 |
| Common voting shares: | | |
| Balance at beginning of year | 84,801,732 | 85,309,107 |

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| | | |
|---------------------------------------|------------|------------|
| Conversion of performance share units | 60,000 | - |
| Conversion of restricted share units | 3,112 | 190,224 |
| Shares repurchased and cancelled | - | (697,599) |
| Balance at end of period | 84,864,844 | 84,801,732 |

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11. Legal Proceedings

In the normal course of business, the Company may become involved in various claims litigation and legal proceedings. As at March 31, 2009, the Company was not a party to any material litigation or arbitration proceedings.

12. Segment Reporting

Effective January 1, 2009, as a result of our recent acquisition of Marlborough Underwriting Agency Limited (“Marlborough”), the managing agency for Lloyd’s Syndicate 1861, management views the Company as being organized into three reporting segments: Reinsurance, Lloyd’s and Insurance. Our Lloyd’s segment includes the business generated through the Lloyd’s Syndicate 1861 and Marlborough. Syndicate 1861, based in London, primarily provides property and short-tail specialty and casualty reinsurance for risks such as energy, hull and cargo, marine liability, engineering and aviation. Syndicate 1861 began writing business for the benefit of Flagstone effective January 1, 2009. As such there are no comparative numbers for the prior year.

The following tables provide a summary of gross and net written and earned premiums, underwriting results, a reconciliation of underwriting income to income before income taxes and interest in earnings of equity investments, total assets, and ratios for each of our reporting segments for the three months ended March 31, 2009 and 2008:

| | For the Three Months Ended March 31, 2009 | | | | | For the Three Months Ended March 31, 2008 | | | | |
|-----------------------------------|---|-----------|-----------|--------------------------------------|------------|---|-----------|--------------------------------------|------------|--|
| | Reinsurance | Lloyd's | Insurance | Inter-segment Eliminations (1) | Total | Reinsurance | Insurance | Inter-segment Eliminations (1) | Total | |
| Gross premiums written | \$ 303,794 | \$ 48,979 | \$ 16,722 | \$ (8,010) | \$ 361,485 | \$ 223,141 | \$ 19,105 | \$ - | \$ 242,246 | |
| Premiums ceded | (67,635) | (5,149) | (10,895) | 8,010 | (75,669) | (5,320) | (11,160) | 466 | (16,014) | |
| Net premiums written | 236,159 | 43,830 | 5,827 | - | 285,816 | 217,821 | 7,945 | 466 | 226,232 | |
| Net premiums earned | \$ 166,596 | \$ 6,443 | \$ (162) | \$ (42) | \$ 172,835 | \$ 128,121 | \$ 7,136 | \$ - | \$ 135,257 | |
| Other related income | 1,027 | 2,020 | 5,606 | (3,623) | 5,030 | 212 | 829 | - | 1,041 | |
| Loss and loss adjustment expenses | (71,230) | (5,331) | (95) | 62 | (76,594) | (39,802) | 35 | - | (39,767) | |
| Acquisition costs | (27,375) | (1,037) | (3,269) | 3,644 | (28,037) | (20,910) | (3,255) | - | (24,165) | |
| General and administrative | (28,043) | (3,834) | (2,423) | - | (34,300) | (24,133) | (2,416) | - | (26,549) | |

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expenses

| | | | | | | | | |
|--|--------------|------------|-----------|-------|--------------|--------------|-----------|----------------|
| Underwriting | | | | | | | | |
| Income (Loss) | \$ 40,975 | \$ (1,739) | \$ (343) | \$ 41 | \$ 38,934 | \$ 43,488 | \$ 2,329 | \$ - \$ 45,817 |
| Loss ratio (2) | 42.8% | 82.7% | 1.7% | | 44.3% | 31.1% | -0.4% | 29.4% |
| Acquisition cost ratio (2) | 16.4% | 16.1% | 60.1% | | 16.2% | 16.3% | 40.9% | 17.9% |
| General and administrative expense ratio (2) | 16.8% | 59.5% | 44.5% | | 19.9% | 18.8% | 30.3% | 19.6% |
| Combined ratio (2) | 76.0% | 158.3% | 106.3% | | 80.4% | 66.2% | 70.8% | 66.9% |
| Total assets | \$ 2,339,516 | \$ 52,855 | \$ 79,668 | | \$ 2,472,039 | \$ 2,153,579 | \$ 88,306 | \$ 2,241,885 |

Reconciliation:

| | | |
|---|-----------|-----------|
| Underwriting | | |
| Income | \$ 38,934 | \$ 45,817 |
| Net investment (loss) income | (1,753) | 18,696 |
| Net realized and unrealized losses - investments | (1,899) | (12,412) |
| Net realized and unrealized gains (losses) - other | 7,430 | (12,237) |
| Other income | 139 | 683 |
| Interest expense | (3,557) | (5,340) |
| Net foreign exchange (losses) gains | (1,097) | 6,699 |
| Income before income taxes and interest in earnings of equity investments | \$ 38,197 | \$ 41,906 |

(1) Inter segment eliminations for 2009 relate to a quota share arrangement between Flagstone Suisse and Island Heritage.

(2) For insurance segment all ratios calculated using expenses divided by net premiums earned plus other related income.

FLAGSTONE REINSURANCE HOLDINGS LIMITED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Amounts in tables expressed in thousands of U.S. dollars, except for ratios, share and per share amounts)

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13. Related Party Transactions

On March 6, 2009, the Company entered into a Share Purchase Agreement (“IAL 7X Agreement”) with the Company’s Executive Chairman, Mark Byrne (“Mr. Byrne”) to acquire 100% of the issued and outstanding common voting shares of IAL 7X Leasing Limited (“IAL 7X”) for a cash purchase price of \$10,000. Mr. Byrne owned 100% of the issued and outstanding common voting shares of IAL 7X. The purchase price equaled the value of the net assets acquired, inclusive of debt of \$14.3 million due to Banc of America Leasing and Capital LLC (“BoA”). IAL 7X owned, as its principal asset, a delivery slot for a Dassault Falcon 7X aircraft (“the 7X”). IAL 7X had made progress payments of \$14.0 million as of March 6, 2009 and had recorded such payments as purchase deposits on its balance sheet. IAL 7X has entered into an agreement with BoA for the financing of the progress payments. The agreement expires on June 30, 2009. Mr. Byrne served as guarantor of the financing with BoA and this guarantee was replaced with one from the Company. The 7X is expected to be delivered in 2010 for an estimated cost of \$44.0 million (the “contract price”). This acquisition does not meet the criteria of a business combination under SFAS No. 141(revised 2007), “Business Combinations” and has been accounted for as an acquisition of an asset.

Mr. Byrne and the Company have agreed that upon delivery of the aircraft, the Company will either sell the aircraft or retain it as determined by the Board according to the Company’s needs at that time. If the aircraft is not sold the Company will have it appraised by two independent appraisers. If the sale price, or appraisal value, is greater than the contract price, the Company will pay Mr. Byrne 85% of the excess in cash. If the sale price, or appraisal value, is less than the contract price, Mr. Byrne will reimburse the Company 100% of the shortfall in cash.

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

The following is a discussion and analysis of our financial condition as at March 31, 2009 and December 31, 2008 and our results of operations for the three months ended March 31, 2009 and 2008. This discussion should be read in conjunction with our unaudited condensed consolidated financial statements and related notes included in Part 1, Item 1 of this Form 10-Q and with "Management's Discussion and Analysis of Financial Condition and Results of Operations", and the audited consolidated financial statements and notes thereto, presented under Item 7 and Item 8, respectively, of the Company's Annual Report on Form 10-K for the year ended December 31, 2008. Some of the information contained in this discussion and analysis is included elsewhere in this document, including information with respect to our plans and strategy for our business, and includes forward-looking statements that involve risks and uncertainties. Please see the "Cautionary Statement Regarding Forward-Looking Statements" for more information. You should review Item 1A, "Risk Factors" contained in our Form 10-K, filed with the SEC on March 13, 2009, for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements.

References in this Quarterly Report on Form 10-Q to the "Company", "Flagstone", "we", "us", and "our" refer to Flagstone Reinsurance Holdings Limited and/or its subsidiaries, including Flagstone Réassurance Suisse SA, its wholly-owned Switzerland reinsurance company, Marlborough Underwriting Agency Limited, its United Kingdom Lloyd's managing agency, Island Heritage Holdings Ltd., its Cayman Islands-based insurance holding company, Flagstone Alliance Insurance & Reinsurance PLC, its wholly-owned Cypriot insurance and reinsurance company, Flagstone Reinsurance Africa Limited, its South African reinsurance company, Mont Fort Re Ltd., its wholly-owned Bermuda reinsurance company, and any other direct or indirect wholly-owned subsidiary, unless the context suggests otherwise. References to "Flagstone Suisse" refer to Flagstone Réassurance Suisse SA and its wholly-owned subsidiaries and its Bermuda branch. References to "Marlborough" refer to Marlborough Underwriting Agency Limited and its wholly-owned subsidiaries as well as Lloyd's Syndicate 1861. References to "Island Heritage" refer to Island Heritage Holdings Ltd. and its subsidiaries. References to "Flagstone Alliance" refer to Flagstone Alliance Insurance & Reinsurance PLC and its subsidiaries. References to "Flagstone Africa" refer to Flagstone Reinsurance Africa Limited. References in this Form 10-Q to "dollars" or "\$" are to the lawful currency of the United States of America, unless the context otherwise requires. All amounts in the following tables are expressed in thousands of U.S. dollars, except share amounts, per share amounts and percentages.

Executive Overview

We are a global reinsurance and insurance company. Effective January 1, 2009, as a result of our recent acquisition of Marlborough, the managing agency for Lloyd's Syndicate 1861, management views the Company as being organized into three business segments: Reinsurance, Lloyd's and Insurance. Through our Reinsurance segment, we write primarily property, property catastrophe and short-tail specialty and casualty reinsurance. Through our Lloyd's segment, we write primarily property and short-tail specialty and casualty reinsurance focused on the energy, hull and cargo, marine liability, engineering and aviation business sectors. Through our Insurance segment, we primarily write property insurance for homes, condominiums and office buildings in the Caribbean region.

Because we have a limited operating history, period to period comparisons of our results of operations are limited and may not be meaningful in the near future. Our financial statements are prepared in accordance with U.S. GAAP and our fiscal year ends on December 31. Since a substantial portion of the reinsurance we write provides protection from damages relating to natural and man-made catastrophes, our results depend to a large extent on the frequency and severity of such catastrophic events, and the specific insurance coverages we offer to clients affected by these events. This may result in volatility in our results of operations and financial condition. In addition, the amount of

premiums written with respect to any particular line of business may vary from quarter to quarter and year to year as a result of changes in market conditions.

We measure our financial success through long term growth in diluted book value per share plus accumulated dividends measured over intervals of three years, which we believe is the most appropriate measure of the performance of the Company, a measure that focuses on the return provided to the Company's common shareholders. Diluted book value per share is obtained by dividing Flagstone's shareholders' equity by the number of common shares and common share equivalents outstanding.

We derive our revenues primarily from net premiums earned from the reinsurance and insurance policies we write, net of any retrocessional or reinsurance coverage purchased, net investment income from our investment portfolio, and fees for services provided. Premiums are generally a function of the number and type of contracts we write, as well as prevailing market prices. Premiums are normally due in installments and earned over the contract term, which ordinarily is twelve months.

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Our expenses consist primarily of the following types: loss and loss adjustment expenses incurred on the policies of reinsurance and insurance that we sell; acquisition costs which typically represent a percentage of the premiums that we write; general and administrative expenses which primarily consist of salaries, benefits and related costs, including costs associated with awards under our PSU and RSU Plans, and other general operating expenses; interest expenses related to our debt obligations; and noncontrolling interest, which represents the interest of external parties with respect to the net income of Mont Fort, Island Heritage, and Flagstone Africa. We are also subject to taxes in certain jurisdictions in which we operate; however, since the majority of our income to date has been earned in Bermuda, a non-taxable jurisdiction, the tax impact on our operations has historically been minimal. As a result of the merger between Flagstone Reinsurance Limited and Flagstone Suisse on September 30, 2008, we expect our tax expense to increase to approximate our effective Swiss Federal tax rate of approximately 8% on the portion of underwriting profits, if any, generated by Flagstone Suisse, excluding the underwriting profits generated in Bermuda through the Flagstone Suisse branch office.

The Company reports its results to the chief operating decision maker based on three reporting segments: Reinsurance, Lloyd's and Insurance. The Company regularly reviews its financial results and assesses performance on the basis of these three operating segments.

Those segments are more fully described as follows:

Reinsurance

Our Reinsurance segment has three main units:

- (1) **Property Catastrophe Reinsurance.** Property catastrophe reinsurance contracts are typically "all risk" in nature, meaning that they protect against losses from earthquakes and hurricanes, as well as other natural and man-made catastrophes such as tornados, wind, fires, winter storms, and floods (where the contract specifically provides for coverage). Losses on these contracts typically stem from direct property damage and business interruption. To date, property catastrophe reinsurance has been our most important product. We write property catastrophe reinsurance primarily on an excess of loss basis. In the event of a loss, most contracts of this type require us to cover a subsequent event and generally provide for a premium to reinstate the coverage under the contract, which is referred to as a "reinstatement premium". These contracts typically cover only specific regions or geographical areas, but may be on a worldwide basis.
- (2) **Property Reinsurance.** We also provide reinsurance on a pro rata share basis and per risk excess of loss basis. Per risk reinsurance protects insurance companies on their primary insurance risks on a single risk basis, for example, covering a single large building. All property per risk and pro rata business is written with loss limitation provisions, such as per occurrence or per event caps, which serve to limit exposure to catastrophic events.
- (3) **Short-tail Specialty and Casualty Reinsurance.** We also provide short-tail specialty and casualty reinsurance for risks such as aviation, energy, accident and health, satellite, marine and workers' compensation catastrophe. Most short-tail specialty and casualty reinsurance is written with loss limitation provisions.

Lloyd's

Our Lloyd's segment includes the business generated through the Lloyd's Syndicate 1861 and Marlborough. Syndicate 1861 primarily provides property and short-tail specialty and casualty reinsurance for risks such as energy, hull and

cargo, marine liability, engineering and aviation.

Insurance

Our Insurance segment includes insurance business generated through Island Heritage. Island Heritage is a property insurer based in the Cayman Islands which is primarily in the business of insuring homes, condominiums and office buildings in the Caribbean region.

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Critical Accounting Policies

Critical accounting policies at March 31, 2009 have not changed compared to December 31, 2008. The Company's critical accounting policies are discussed in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

It is important to understand our accounting policies in order to understand our financial position and results of operations. Our unaudited condensed consolidated financial statements contain certain amounts that are inherently subjective in nature and have required management to make assumptions and best estimates to determine the reported values. If events or other factors, including those described in Item 1A, "Risk Factors," of our Form 10-K, cause actual events or results to differ materially from management's underlying assumptions or estimates, there could be a material adverse effect on our results of operations, financial condition and liquidity.

New Accounting Pronouncements

Adoption of new accounting pronouncements

On January 1, 2009, the Company adopted the provisions of the SFAS No. 160, which requires all entities to report noncontrolling interests in subsidiaries (formerly known as minority interests) as a separate component of equity in the consolidated balance sheets, to clearly identify consolidated net income attributable to the parent and to the noncontrolling interest on the face of the consolidated statement of operations and to provide sufficient disclosure that clearly identifies and distinguishes between the interest of the parent and the interests of noncontrolling owners. SFAS 160 also establishes accounting and reporting standards for changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. The effect of adopting this Statement was immaterial to our financial statements.

On January 1, 2009, the Company adopted the provisions of SFAS 161. The provisions of SFAS 161 amend and expand the disclosure requirements for derivative instruments and hedging activities by requiring enhanced disclosures about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (iii) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The effect of adopting this Statement was immaterial to our financial statements.

New accounting pronouncements issued during 2009 impacting the Company are as follows:

On April 9, 2009, the FASB issued three FSPs intended to provide additional application guidance and enhance disclosures regarding fair value measurements and impairments of securities: FSP FAS 157-4, FSP FAS 107-1 and APB 28-1, FSP FAS 115-2 and FAS 124-2.

FSP FAS 157-4 provides guidelines for making fair value measurements more consistent with the principles presented in FASB SFAS 157. FSP FAS 157-4 relates to determining fair values when there is no active market or where the price inputs being used represent distressed sales. It reaffirms what SFAS 157 states is the objective of fair value measurement—to reflect how much an asset would be sold for in an orderly transaction (as opposed to a distressed or forced transaction) at the date of the financial statements under current market conditions. Specifically, it reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when

markets have become inactive.

FSP FAS 107-1 and APB 28-1 enhance consistency in financial reporting by increasing the frequency of fair value disclosures. The guidance relates to fair value disclosures for any financial instruments that are not currently reflected on the balance sheet of companies at fair value. Prior to issuing this FSP, fair values for these assets and liabilities were only disclosed once a year. The FSP now requires these disclosures on a quarterly basis, providing qualitative and quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value.

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FSP FAS 115-2 and FSP FAS 124-2 provide additional guidance designed to create greater clarity and consistency in accounting for and presenting impairment losses on securities. The guidance is intended to bring greater consistency to the timing of impairment recognition, and provide greater clarity to investors about the credit and noncredit components of impaired debt securities that are not expected to be sold. The measure of impairment in comprehensive income remains fair value. The FSP also requires increased and more timely disclosures sought by investors regarding expected cash flows, credit losses, and an aging of securities with unrealized losses.

These FSPs are effective for interim and annual periods ending after June 15, 2009. The Company has considered the provisions of these FSPs on the current quarter and determined that their application does not have an effect on the Company's current financial position.

Results of Operations - For the Three Months Ended March 31, 2009 and 2008

The Company's reporting currency is the U.S. dollar. The Company's subsidiaries have one of the following functional currencies: U.S. dollar, Swiss franc, Euro, British pound, Canadian dollar, Indian rupee, or South African rand. As a significant portion of the Company's operations are transacted in foreign currencies, fluctuations in foreign exchange rates may affect period-to-period comparisons. To the extent that fluctuations in foreign currency exchange rates affect comparisons, their impact has been quantified, when possible, and discussed in each of the relevant sections. See Note 2 to the consolidated financial statements in Item 8, "Financial Statements and Supplementary Data", in the Company's Annual Report on Form 10-K filed with the SEC on March 13, 2009, for a discussion on translation of foreign currencies.

| U.S. dollar strengthened against: | For the three months ended March 31, 2009 |
|-----------------------------------|--|
| Canadian dollar | 2.1% |
| Swiss franc | 6.5% |
| Euro | 4.4% |
| British pound | 0.2% |
| Indian rupee | 4.0% |
| South African rand | 2.4% |

Summary Overview

We generated net income attributable to Flagstone of \$35.7 million for the three months ended March 31, 2009, compared to net income attributable to Flagstone of \$32.9 million for the same period in 2008. Our results of operations include the results of Flagstone Africa beginning in July 2008, the results of Flagstone Alliance beginning in October 2008 and the results of Marlborough beginning in November 2008. The increase in net income attributable to Flagstone for the three months ended March 31, 2009 of \$2.8 million, as compared to the same period in 2008 is primarily due to:

| | For the three months ended March 31, 2009 |
|------------------------------------|--|
| - change in underwriting income of | \$ (6.9) million |

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| | | |
|--|----|----------------|
| - change in investment income of | \$ | (20.4) million |
| - change in net realized and unrealized losses on investments and other derivative instruments and foreign exchange gains of | \$ | 22.3 million |
| - change in income attributable to noncontrolling interest of | \$ | 5.4 million |
| - change in other income and expenses of | \$ | 2.4 million |

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These items are discussed in the following sections.

As a result of our net income attributable to Flagstone for the three months ended March 31, 2009, our diluted book value per share increased to \$11.60 compared to \$11.30 at December 31, 2008, representing an increase of 3.0%, inclusive of dividends.

The following table sets forth our selected unaudited consolidated statement of operations data for each of the periods indicated.

| | For the Three Months Ended | |
|---|----------------------------|----------------|
| | March 31, 2009 | March 31, 2008 |
| Gross premiums written | \$ 361,485 | \$ 242,246 |
| Net premiums written | 285,816 | 226,232 |
| Net premiums earned | 172,835 | 135,257 |
| Loss and loss adjustment expenses | 76,594 | 39,767 |
| Acquisition costs and general and administrative expenses | 62,337 | 50,714 |
| Underwriting income | 38,934 | 45,817 |
| Net investment (loss) income | (1,753) | 18,696 |
| Net realized and unrealized losses - investments | (1,899) | (12,412) |
| Net realized and unrealized gains (losses) - other | 7,430 | (12,237) |
| Net income attributable to Flagstone | 35,743 | 32,860 |
| Earnings per common share outstanding—Basic | \$ 0.42 | \$ 0.38 |
| Earnings per common share outstanding—Diluted | \$ 0.42 | \$ 0.38 |
| Loss ratio | 44.3% | 29.4% |
| Expense ratio | 36.1% | 37.5% |
| Combined ratio | 80.4% | 66.9% |

Outlook and Trends

In the wake of the ongoing global financial crisis, which originated in the third quarter of 2008, and coincided with increased land-falling hurricane activity (2nd worst catastrophe year) in the United States of Hurricanes Dolly, Gustav and Ike, this resulted in poor investment results, capital erosion, and higher than average combined ratios for most (re)insurers around the globe. This reduction in (re)insurer capital materialized into increased demand for reinsurance at the same time that supply was constrained for the important January 1 renewal season. While market price increases varied by line of business and region, we observed a double digit level of price increase on average for loss-free accounts and a 20% or more increase on programs impacted by the hurricanes and other losses. In addition to the price increases, capacity for the peak U.S. catastrophe zones for wind exposed business was fairly tight, raising the required hurdle price for programs to get completed. While submission of the individual program information was generally early, the renewals were completed late in the season because of the magnitude of price increase and securing of adequate capacity. This market has also seen a lack of any material new capacity emerging as no new “Class of 2009” has thus far emerged, bringing any new capital or capacity to this hardening market.

Against this backdrop we expect to see continued firming of property catastrophe reinsurance price and terms and conditions as we head into the second and third quarter, June and July renewals, an increasingly larger segment of the annual reinsurance premium generated for property catastrophe business where Florida, Gulf region, and the East coast are the most significant exposures being placed. We likewise expect capacity to be down overall, coupled with a level of price increase likely to exceed that seen at January 1.

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Underwriting Results by Segment

The Company is organized into three reportable segments, Reinsurance, Lloyd's and Insurance. Our Reinsurance segment provides reinsurance through our property, property catastrophe and short-tail specialty and casualty reinsurance business units. Our Lloyd's segment primarily provides property and short-tail specialty and casualty reinsurance for risks such as energy, hull and cargo, marine liability, engineering and aviation. Our Insurance segment provides insurance through Island Heritage.

The following tables provide a summary of gross and net written and earned premiums, underwriting results, total assets and ratios for each of our business segments for the three months ended March 31, 2009 and 2008:

| | For the Three Months Ended March 31, 2009 | | | | | For the Three Months Ended March 31, 2008 | | | | |
|-------------------------------------|---|------------|-----------|--------------------------------------|------------|---|-----------|--------------------------------------|------------|--|
| | Reinsurance | Lloyd's | Insurance | Inter-segment Eliminations (1) | Total | Reinsurance | Insurance | Inter-segment Eliminations (1) | Total | |
| Gross premiums written | \$ 303,794 | \$ 48,979 | \$ 16,722 | \$ (8,010) | \$ 361,485 | \$ 223,141 | \$ 19,105 | \$ - | \$ 242,246 | |
| Premiums ceded | (67,635) | (5,149) | (10,895) | 8,010 | (75,669) | (5,320) | (11,160) | 466 | (16,014) | |
| Net premiums written | 236,159 | 43,830 | 5,827 | - | 285,816 | 217,821 | 7,945 | 466 | 226,232 | |
| Net premiums earned | \$ 166,596 | \$ 6,443 | \$ (162) | \$ (42) | \$ 172,835 | \$ 128,121 | \$ 7,136 | \$ - | \$ 135,257 | |
| Other related income | 1,027 | 2,020 | 5,606 | (3,623) | 5,030 | 212 | 829 | - | 1,041 | |
| Loss and loss adjustment expenses | (71,230) | (5,331) | (95) | 62 | (76,594) | (39,802) | 35 | - | (39,767) | |
| Acquisition costs | (27,375) | (1,037) | (3,269) | 3,644 | (28,037) | (20,910) | (3,255) | - | (24,165) | |
| General and administrative expenses | (28,043) | (3,834) | (2,423) | - | (34,300) | (24,133) | (2,416) | - | (26,549) | |
| Underwriting Income (Loss) | \$ 40,975 | \$ (1,739) | \$ (343) | \$ 41 | \$ 38,934 | \$ 43,488 | \$ 2,329 | \$ - | \$ 45,817 | |
| Loss ratio (2) | 42.8% | 82.7% | 1.7% | | 44.3% | 31.1% | -0.4% | | 29.4% | |
| Acquisition cost ratio (2) | 16.4% | 16.1% | 60.1% | | 16.2% | 16.3% | 40.9% | | 17.9% | |
| General and administrative | 16.8% | 59.5% | 44.5% | | 19.9% | 18.8% | 30.3% | | 19.6% | |

| | | | | | | | |
|-----------------------|--------------|-----------|-----------|--------------|--------------|-----------|--------------|
| expense ratio (2) | | | | | | | |
| Combined ratio (2) | 76.0% | 158.3% | 106.3% | 80.4% | 66.2% | 70.8% | 66.9% |
| Total assets | \$ 2,339,516 | \$ 52,855 | \$ 79,668 | \$ 2,472,039 | \$ 2,153,579 | \$ 88,306 | \$ 2,241,885 |

(1) Inter segment eliminations for 2009 relate to a quota share arrangement between Flagstone Suisse and Island Heritage.

(2) For insurance segment all ratios calculated using expenses divided by net premiums earned plus other related income.

Gross Premiums Written

Details of consolidated gross premiums written by line of business and geographic area of risk insured are provided below:

| Line of business | Three Months Ended March 31, 2009 | | Three Months Ended March 31, 2008 | |
|-----------------------------------|--------------------------------------|------------------------|--------------------------------------|------------------------|
| | Gross premiums written | Percentage of total | Gross premiums written | Percentage of total |
| Property catastrophe | \$ 200,740 | 55.5% | \$ 164,616 | 68.0% |
| Property | 51,861 | 14.3% | 18,921 | 7.8% |
| Short-tail specialty and casualty | 92,162 | 25.6% | 39,604 | 16.3% |
| Insurance | 16,722 | 4.6% | 19,105 | 7.9% |
| Total | \$ 361,485 | 100.0% | \$ 242,246 | 100.0% |

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| Geographic area of risk insured(1) | Three Months Ended March 31, 2009 | | Three Months Ended March 31, 2008 | |
|------------------------------------|--------------------------------------|------------------------|--------------------------------------|------------------------|
| | Gross premiums written | Percentage of total | Gross premiums written | Percentage of total |
| Caribbean(2) | \$ 21,089 | 5.8% | \$ 25,720 | 10.6% |
| Europe | 70,628 | 19.6% | 64,675 | 26.7% |
| Japan and Australasia | 11,918 | 3.3% | 9,292 | 3.8% |
| North America | 125,736 | 34.8% | 78,683 | 32.5% |
| Worldwide risks(3) | 111,147 | 30.7% | 56,864 | 23.5% |
| Other | 20,967 | 5.8% | 7,012 | 2.9% |
| Total | \$ 361,485 | 100.0% | \$ 242,246 | 100.0% |

- (1) Except as otherwise noted, each of these categories includes contracts that cover risks located primarily in the designated geographic area.
- (2) Gross written premiums related to the Insurance segment are included in the Caribbean geographic area.
- (3) This geographic area includes contracts that cover risks in two or more geographic zones.

Reinsurance Segment

Overview

The net underwriting income for the Reinsurance segment for the three months ended March 31, 2009 amounted to \$41.0 million compared to \$43.5 million for the three months ended March 31, 2008. The decrease in net underwriting results is primarily related to losses incurred on winter storm Klaus and the Australia bush fires, higher acquisition and general and administration costs, partially offset by higher levels of premiums earned.

Gross premiums written for our reinsurance segment in the first quarter of 2009 were \$303.8 million compared to \$223.1 million for the same period in 2008, an increase in gross premiums written of \$80.7 million, or 36.2%. The increase was due to increased participation on a number of key accounts and new programs, due to rate increases on catastrophe exposed treaties, to the contribution of Flagstone Africa and Flagstone Alliance of \$24.2 million which were not subsidiaries in 2008, partially offset by the non renewal of certain treaties that did not meet the Company's profitability objectives and a decrease in non-U.S. dollar premiums due to the strengthening of the U.S. dollar.

Our Reinsurance segment comprises three lines of business outlined below.

Gross Premiums Written

- a. Property catastrophe reinsurance

Gross property catastrophe premiums written for the three months ended March 31, 2009 were \$208.7 million, compared to \$164.6 million for the three months ended March 31, 2008. The increase of \$44.1 million, or 26.8%, in property catastrophe premiums written is primarily due to a hardening of prices in the property catastrophe market which had the dual impact of (i) increasing premiums written on many contract renewals and (ii) increased business through participation in new programs.

During the three months ended March 31, 2009, we recorded \$2.1 million of gross reinstatement premiums primarily related to Hurricane Ike and Winter Storm Klaus, compared to \$1.2 million recorded for the three months ended March 31, 2008, which was primarily related to Windstorm Emma.

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b. Property reinsurance

Gross property premiums written for the three months ended March 31, 2009 were \$42.8 million, compared to \$18.9 million for the three months ended March 31, 2008, representing an increase of \$23.8 million, or 126.0%. Proportional property premiums increased \$21.4 million for the three months ended March 31, 2009, compared to the same period in 2008 while non-proportional premiums increased \$2.4 million over the same period last year. The increase in proportional property premiums is primarily due to a new quota share program as well as increased signed shares by existing clients.

During the three months ended March 31, 2009, we recorded \$0.7 million of gross reinstatement premiums primarily related to per risk covers, compared to \$1.5 million recorded for the three months ended March 31, 2008.

c. Short tail specialty and casualty reinsurance

Short-tail specialty and casualty reinsurance premiums were \$52.3 million for the three months ended March 31, 2009, compared to \$39.6 million for the three months ended March 31, 2008, representing an increase of \$12.7 million, or 32.0%. The increase is primarily related to premiums generated through Flagstone Alliance. Proportional premiums increased \$17.5 million while non-proportional premiums decreased \$4.8 million for the three months ended March 31, 2009, compared to the same period in 2008. The increase in proportional premiums is principally due to the addition of new clients in the first quarter of 2009, and new contracts with existing clients. The decrease in non-proportional premiums is primarily due to the non-renewal of a marine ILW program.

During the three months ended March 31, 2009, we recorded \$1.3 million, of gross reinstatement premiums primarily related to marine, energy and aviation contracts, compared to \$0.8 million in the three months ended March 31, 2008.

During 2009, we expect to continue increasing our specialty writings based on our assessment of the market environment.

Premiums Ceded

In the normal course of its business, the Company purchases reinsurance in order to manage its exposures. The amount and type of reinsurance that it enters into is dependent on a variety of factors, including the cost of a particular reinsurance cover and the nature of its gross premiums written during a particular period.

Reinsurance purchases to date have represented prospective cover; that is, ceded reinsurance purchased to protect it against the risk of future losses as opposed to covering losses that have already incurred but have not been paid. The majority of these contracts are excess-of-loss contracts covering one or more lines of business. To a lesser extent we have also purchased quota share reinsurance with respect to specific lines of business. We also purchase industry loss warranty policies which provide coverage for certain losses provided they are triggered by events exceeding a specified industry loss size.

Reinsurance premiums ceded for the three months ended March 31, 2009 and 2008, were \$67.6 million and \$5.3 million (22.3% and 2.4% of gross reinsurance premiums written), respectively, representing an increase of \$62.3 million. The increase in amount of reinsurance premiums ceded was designed to increase our underwriting capacity

and provide additional protection against potential high severity loss events.

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Various factors will continue to affect our appetite and capacity to write and retain risk. These include the impact of changes in frequency and severity assumptions used in our models and the corresponding pricing required to meet our return targets, evolving industry-wide capital requirements, increased competition, and other considerations.

Net Premiums Earned

As the levels of net premiums written increase, the levels of net premiums earned also increase. Reinsurance net premiums earned were \$166.6 million for the three months ended March 31, 2009, compared to \$128.1 million for the three months ended March 31, 2008, representing an increase of \$38.5 million, or 30.0%. The increases are primarily due to higher levels of premium writings and the impact of reinstatements earned in the first quarter of 2009.

Underwriting Expenses

a. Loss and loss adjustment expenses

Loss and loss adjustment expenses for the three months ended March 31, 2009 were \$71.2 million, or 42.8% of net premiums earned, compared to \$39.8 million, or 31.1% of net premiums earned, for the three months ended March 31, 2008. The increase in the loss ratio from the first quarter of 2008 was primarily due to the impact of higher reinsurance purchases on net premiums earned and due to more severe catastrophic events in the first quarter of 2009 than in the same period in 2008, including gross losses related to winter storm Klaus (\$13.2 million) and Australia bush fires (\$10.3 million). During the quarter ended March 31, 2009, we also revisited our loss estimates for previous loss events. Based on updated estimates provided by clients and brokers, we have recorded net favorable developments for prior loss events for the 2007 accident year of \$5.4 million, primarily related to reserve releases on the United Kingdom floods and New South Wales storms. There was mild deterioration in the loss reserves related to the 2008 accident year primarily related to some late reporting from cedents on Hurricanes Ike and Gustav offset by reserve releases related to the Chinese earthquake. During the first quarter of 2008, there were no significant loss events.

b. Acquisition costs

Acquisition costs for the three months ended March 31, 2009 were \$27.4 million compared to \$20.9 million for the three months ended March 31, 2008. The acquisition cost ratio, which is equal to acquisition cost expenses over net premiums earned, for the three months ended March 31, 2009 was 16.4% compared to 16.3% for the three months ended March 31, 2008.

c. General and administrative expenses

General and administrative expenses for the three months ended March 31, 2009, were \$28.0 million compared to \$24.1 million in the three months ended March 31, 2009. The increase in the general and administrative expenses for the three months ended March 31, 2009 compared to the same period in 2008 is primarily due to increased costs associated with additional staff as a result of the acquisition of Flagstone Africa and Flagstone Alliance during the second and third quarters of 2008, respectively.

Lloyd's Segment

Overview

As a result of the acquisition of Marlborough, the managing agency for Lloyd's Syndicate 1861, in November 2008, the Company established a new reporting segment. Syndicate 1861 began writing business for the benefit of Flagstone effective January 1, 2009. As such there are no comparative numbers for the prior year. The net underwriting loss for the Lloyd's segment for the three months ended March 31, 2009 amounted to \$1.7 million. Due to the start up nature of the 2009 year of account for Syndicate 1861, the level of earned premium income is slowly ramping up with new business, placing strain on the underwriting result as we have incurred expenses for the full quarter. In addition, due to the start up nature there is a very limited level of funds available and therefore minimal investment income has been earned to date.

Gross Premiums Written

Gross premiums written were \$49.0 million for the three months ended March 31, 2009 and consist primarily of property and specialty lines.

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Premiums Ceded

Premiums ceded for the three months ended March 31, 2009 were \$5.1 million (10.5% of gross premiums written). In the normal course of its business, the Company purchases reinsurance in order to manage its exposures. The amount and type of reinsurance that it enters into is dependent on a variety of factors, including the cost of a particular reinsurance cover and the nature of its gross premiums written during a particular period.

Net Premiums Earned

Net premiums earned totaled \$6.4 million for the three months ended March 31, 2009. The net premiums earned are a function of the timing and amount of premiums written and given the start up nature of the syndicate's writings, premiums earned are small relative to the writings during the current quarter.

Other Related Income

Other related income, derived from services provided to syndicates and third parties, totaled \$2.0 million for the three months ended March 31, 2009.

Underwriting Expenses

a. Loss and loss adjustment expenses

Loss and loss adjustment expenses amounted to \$5.3 million for the three months ended March 31, 2009. There were no significant loss events recorded during the quarter ended March 31, 2009.

b. Acquisition costs

Acquisition costs totaled \$1.0 million for the three months ended March 31, 2009. The acquisition cost ratio, which is equal to acquisition cost expenses over net premiums earned, for the three months ended March 31, 2009 was 16.1%. Acquisition costs include brokerage, gross commission costs, profit commission and premium taxes.

c. General and administrative expenses

General and administrative expenses for the three months ended March 31, 2009 were \$3.8 million. General and administrative expenses include staff and salary related costs, administration expenses and Lloyd's specific costs such as syndicate expenses.

Insurance Segment

Overview

The net underwriting (loss) income for the three months ended March 31, 2009 amounted to \$(0.3) million compared to \$2.3 million for the three months ended March 31, 2008. As Island Heritage significantly changed its reinsurance program effective April 1, 2008, the results for the periods ended March 31, 2009 and March 31, 2008 are not directly comparable.

Gross Premiums Written

Gross premiums written were \$16.7 million for the three months ended March 31, 2009, compared to \$19.1 million for the three months ended March 31, 2008. The decrease is primarily related to the non-renewal of certain contracts which no longer met the Company's profitability targets as well as a reduction in premiums as a result of the cessation of business of the Company's agent in Jamaica. Contracts are written on a per risk basis and consist primarily of property lines. Seasonality is inherent for most Caribbean insurers given that the storm season begins June 1 and concludes November 30. Therefore, proportionally higher volumes of property business are traditionally written in the first two quarters in the fiscal year.

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Premiums Ceded

Insurance premiums ceded for the three months ended March 31, 2009 were \$10.9 million (65.1% of gross premiums written) compared to \$11.2 million (58.4% of gross premiums written) for the three months ended March 31, 2008. Island Heritage's reinsurance program, comprising excess of loss and quota share programs, was significantly changed on April 1, 2008 compared to prior years, resulting in the addition of increased net quota share reinsurance portfolio transfer. The change in the reinsurance program enables Island Heritage to enter into new markets as well as increase penetration in existing markets.

Net Premiums Earned

Net premiums earned totaled \$(0.2) million for the three months ended March 31, 2009, compared to \$7.1 million for the three months ended March 31, 2008. The significant decrease in net premiums earned for the three months ended March 31, 2009, compared to the three months ended March 31, 2008 is due to the difference in the reinsurance program in place for both years.

Other Related Income

Other insurance related income, primarily ceding commissions, totaled \$5.6 million for the three months ended March 31, 2009, compared to \$0.8 million for the three months ended March 31, 2008. The increase in other insurance related income for 2009 is due to the changes in the reinsurance program referred to above, and includes \$3.6 million related to the quota share arrangement between Island Heritage and Flagstone Suisse. This amount is fully eliminated upon consolidation.

Underwriting Expenses

a. Loss and loss adjustment expenses

Loss and loss adjustment expenses (recoveries) amounted to \$0.1 million for the three months ended March 31, 2009, compared to \$(35,000) for the three months ended March 31, 2008. The slight increase in loss and loss adjustment expense in the three months ended March 31, 2009 is primarily related to losses on existing claims and events.

b. Acquisition costs

Acquisition costs totaled \$3.3 million for the three months ended March 31, 2009, which is the same amount incurred during the three months ended March 31, 2008. Acquisition costs include gross commission costs, profit commission, premium taxes, and the change in deferred acquisition costs.

c. General and administrative expenses

General and administrative expenses for the three months ended March 31, 2009 were \$2.4 million, in line with amounts incurred during the three months ended March 31, 2008.

Investment Results

The total return on our investment portfolio, excluding noncontrolling interests in the investment portfolio, comprises investment income and realized and unrealized gains and losses on investments. For the three months ended March 31, 2009, the total return on invested assets was (0.1)%, compared to 0.2% for the three months ended March 31, 2008. The Company modified its asset allocation significantly in the fourth quarter of 2008. Therefore, the results for the periods ended March 31, 2009 and March 31, 2008 are not directly comparable.

The key contributors to the investment performance this quarter were a strong performance from our US Treasury Inflation-Protected Securities (“TIPS”) portfolio, offset by negative performance of U.S. Real Estate and Commodities positions. The key contributors for the same period last year were a positive performance from the TIPS portfolio and a negative performance of equities.

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a. Net investment (loss) income

Net investment (loss) income for the three months ended March 31, 2009 was \$(1.8) million, compared to \$18.7 million for the same period in 2008, a decrease of \$20.5 million. The decrease is principally due to the negative amortization on the TIPS, caused by the impact of negative inflation index and due to lower short-term interest rates in the current quarter. It should be noted that our TIPS portfolio generated a positive total return of 3.9% in the current quarter. However, this return is recorded as \$8.4 million of negative amortization income and \$19.7 million of realized and unrealized gains. In comparison, for the first quarter of 2008, we had recorded \$3.3 million of positive amortization income and \$19.7 million of realized and unrealized gains. Our net investment income (and hence our operating income) may be impacted by large movement in inflation rates.

Investment income is principally derived from interest, dividends and amortization earned on investments, partially offset by investment management and custody fees. The components are set forth in the table below:

| | Three Months Ended | |
|-------------------------------|--------------------|----------------|
| | March 31, 2009 | March 31, 2008 |
| Interest and dividend income | | |
| Cash and cash equivalents | \$ 745 | \$ 4,846 |
| Fixed maturities | 7,383 | 9,196 |
| Short term | 93 | 126 |
| Equity investments | 32 | - |
| Other investments | (36) | 3 |
| Amortization income (expense) | | |
| Fixed maturities | (8,673) | 4,513 |
| Short term | 29 | 161 |
| Other investments | (82) | 83 |
| Investment expenses | (1,244) | (232) |
| Net investment (loss) income | \$ (1,753) | \$ 18,696 |

Substantially all of our fixed maturity investments consisted of investment grade securities. As at March 31, 2009, the average credit rating provided by a recognized national rating agency of our fixed maturity portfolio was AA+ with an average duration of 2.7 years.

b. Net realized and unrealized gains and losses – investments

Our investment portfolio is structured to preserve capital and provide us with a high level of liquidity and is managed to produce a total return. In assessing returns under this approach, we include investment income and realized and unrealized gains and losses generated by the investment portfolio.

Net realized and unrealized losses on our investment portfolio amounted to a \$1.9 million loss for the three months ended March 31, 2009, compared to a \$12.4 million loss for the three months ended March 31, 2008. Losses on our real estate and commodities holdings in 2009 were mostly offset by gains on the TIPS as described above. 2008 losses were mostly attributable to equity positions, which were sold later in 2008.

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The following table is the breakdown of net realized and unrealized gains (losses) - investments in the unaudited condensed consolidated statements of operations into its various components:

| | Three Months Ended | |
|--|--------------------|----------------|
| | March 31, 2009 | March 31, 2008 |
| Net realized (losses) gains on fixed maturities | \$ (244) | \$ 16,406 |
| Net unrealized gains (losses) on fixed maturities | 14,187 | (3,192) |
| Net realized losses on equities | (2,628) | - |
| Net unrealized gains (losses) on equities | 2,580 | (7,634) |
| Net realized and unrealized losses on derivative instruments - investments | (15,096) | (18,182) |
| Net realized and unrealized (losses) gains on other investments | (698) | 190 |
| Total net realized and unrealized losses - investments | \$ (1,899) | \$ (12,412) |

Net realized and unrealized gains on fixed maturities of \$13.9 million for the three months ended March 31, 2009, were primarily due to unrealized gains on the TIPS, partially offset by the widening of credit spreads during the quarter.

Net realized and unrealized losses on equities of \$0.1 million for the three months ended March 31, 2009 were due to the negative performance of the emerging equity markets during the three months ended March 31, 2009.

Net realized and unrealized losses on other investments of \$0.7 million during the three months ended March 31, 2009, were primarily due to the negative performance of the investment funds during the quarter.

The following table is a breakdown of the net realized and unrealized (losses) gains on derivatives included in the table above:

| | Three Months Ended | |
|---|--------------------|----------------|
| | March 31, 2009 | March 31, 2008 |
| Futures contracts | \$ (4,153) | \$ (20,071) |
| Total return swaps | (8,735) | 1,793 |
| Interest rate swaps | - | (346) |
| Foreign currency forward contracts | (3,166) | - |
| Mortgage-backed securities TBA | 958 | 442 |
| Net realized and unrealized losses on derivatives - investments | \$ (15,096) | \$ (18,182) |

Net realized and unrealized losses on futures contracts of \$4.2 million during the three months ended March 31, 2009 were primarily due to \$3.5 million of losses on commodity futures and \$0.5 million of losses on U.S. and global equity futures and \$0.2 million of losses on bond futures. Net realized and unrealized losses on futures contracts of \$20.1 million during the three months ended March 31, 2008 were primarily due to \$29.8 million of losses on U.S. and global equity futures, partially offset by \$7.9 million of gains on commodity futures.

Net realized and unrealized losses on total return swaps of \$8.7 million are due to the negative performance of U.S real estate index.

Net realized and unrealized losses on foreign currency forward contracts of \$3.2 million are related to currency hedges on non-U.S. dollar investment assets.

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Treasury Hedging and Other

Net realized and unrealized gains and losses – other

The Company's policy is to hedge the majority of its non-investment currency exposure with derivative instruments such as foreign currency swaps and forward contracts.

Currency swaps and foreign currency forwards are used to hedge the economic currency exposure of the Company's investment in foreign subsidiaries, primarily our Swiss subsidiary, and to hedge operational balances such as premiums receivable, loss reserves and the portion of our long term debt issued in Euros.

The following table is the breakdown of net realized and unrealized losses - other in the consolidated statements of operations into its various components:

| | Three Months Ended | |
|--|--------------------|----------------|
| | March 31, 2009 | March 31, 2008 |
| Currency swaps | \$ (785) | \$ 1,802 |
| Interest rate swaps | - | (9,194) |
| Foreign currency forward contracts | 7,675 | (5,559) |
| Reinsurance derivatives | 540 | 714 |
| Net realized and unrealized gains (losses) - other | \$ 7,430 | \$ (12,237) |

Net realized and unrealized gains related to these derivative instruments amounted to \$7.4 million for the three months ended March 31, 2009, compared to net realized and unrealized losses \$12.2 million for the three months ended March 31, 2008. These amounts comprise net realized and unrealized gains (losses) on foreign currency forward contracts, interest rate and currency swaps and reinsurance derivatives. We use currency swaps and foreign currency forwards to hedge the economic currency exposure of the Company's investment in foreign subsidiaries, primarily our Swiss subsidiary, and to hedge operational balances such as premiums receivable, loss reserves and the portion of our long term debt issued in Euros.

The Company recorded \$0.8 million of net realized and unrealized losses on foreign currency swaps on our subordinated debt for the three months ended March 31, 2009. The Company did not hold any interest rate swaps in 2009. For the three months ended March 31, 2009, we recorded a \$7.7 million gain on foreign currency forwards on Flagstone Suisse's net assets (undesigned hedge) and operational hedges on reinsurance balances.

Reinsurance derivatives relate to industry loss warranty contracts ("ILWs") that are structured as derivative transactions. The Company recorded premium earned on ILWs determined to be derivatives of \$0.5 million for the three months ended March 31, 2009, versus \$0.7 million for the same period in 2008.

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Interest Expense

Interest expense was \$3.6 million for the three months ended March 31, 2009 compared to \$5.3 million for the three months ended March 31, 2008. Interest expense consists of interest due on outstanding debt securities and the amortization of debt offering expenses. The decrease in interest expense for the three months ended March 31, 2009 compared to the same period in 2008 is primarily related to the decrease in short term interest rates from period to period and the repurchase of \$11.25 million of principal amount of the Company's outstanding \$100.0 million Notes during the second quarter of 2008.

Foreign Exchange

For the three months ended March 31, 2009, we experienced net foreign exchange losses of \$1.1 million compared to gains of \$6.7 million for the three months ended March 31, 2008. For the three months ended March 31, 2009, the net foreign exchange losses were principally experienced on the net monetary asset and liability balances denominated in foreign currencies. The Company's policy is to hedge the majority of its foreign currency exposures with derivative instruments such as foreign currency swaps and forward contracts.

Income Tax Expense

The Company has subsidiaries that operate in various other jurisdictions around the world that are subject to tax in the jurisdictions in which they operate. The significant jurisdictions in which the Company's subsidiaries are subject to tax are Canada, India, South Africa, Switzerland, Cyprus, U.S. Virgin Islands ("USVI") and the United Kingdom. However since the majority of our income to date has been earned in Bermuda where we are exempt from income tax, the Company's tax impact to date has been minimal. During the three months ended March 31, 2009, income tax recovery was \$0.7 million compared to an income tax expense of \$0.9 million for the three months ended March 31, 2008. The decrease for the three months ended March 31, 2009, compared to the same period in 2008, is primarily attributable to the finalization of the 2008 income tax returns. As a result of the merger between Flagstone Reinsurance Limited and Flagstone Suisse on September 30, 2008, we expect our tax expense to increase to approximate our effective Swiss Federal tax rate of approximately 8% on the portion of underwriting profits, if any, generated by Flagstone Suisse, excluding the underwriting profits generated in Bermuda through the Flagstone Suisse branch office.

Noncontrolling Interest

The results of Mont Fort have been included in the Company's unaudited condensed consolidated financial statements, with the portions of Mont Fort's net income and shareholders' equity attributable to the preferred shareholders recorded as noncontrolling interest. In relation to Mont Fort, the Company recorded income attributable to noncontrolling interest of \$2.9 million for the three months ended March 31, 2009, compared to \$7.7 million for the same period in 2008.

The results of operations of Island Heritage have been included in the Company's unaudited condensed consolidated financial statements from July 1, 2007 onwards, with the portions of Island Heritage's net income and shareholders' equity attributable to minority shareholders recorded as noncontrolling interest. The Company recorded a loss attributable to noncontrolling interest of \$0.1 million for the three months ended March 31, 2009, compared to income attributable to noncontrolling interest of \$0.5 million for the three months ended March 31, 2008.

The results of operations of Flagstone Africa have been included in the Company's unaudited condensed consolidated financial statements from June 26, 2008 onwards, with the portions of Flagstone Africa's net income and shareholders' equity attributable to minority shareholders recorded as noncontrolling interest. The Company recorded a loss attributable to noncontrolling interest of \$0.1 million for the three months ended March 31, 2009.

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Comprehensive Income

Comprehensive income attributable to Flagstone for the three months ended March 31, 2009 was \$37.6 million compared to \$30.9 million for the same period in 2008. For the three months ended March 31, 2009, comprehensive income attributable to Flagstone included \$38.5 million of net income, \$1.9 million for the change in the currency translation adjustment, \$(0.2) million for the change in the defined benefit pension plan obligation and \$(2.6) million related to comprehensive income attributable to noncontrolling interest in subsidiaries, compared to \$41.0 million of net income, \$(1.4) million for the change in the currency translation adjustment and \$(0.5) million for the change in the defined benefit pension plan obligation and \$(8.2) million related to comprehensive income attributable to noncontrolling interest in subsidiaries for the three months ended March 31, 2008. The currency translation adjustment is as a result of the translation of our foreign subsidiaries into U.S. dollars, net of transactions designated as hedges of net foreign investments. The Company has entered into certain foreign currency forward contracts that it has designated as hedges in order to hedge its net investment in foreign subsidiaries. To the extent that the contract is effective as a hedge, both the realized and unrealized gains and losses associated with the designated hedge instruments are recorded in other comprehensive income as part of the cumulative translation adjustment. The Company designated \$181.8 million and \$337.7 million of foreign currency forwards contractual value as hedge instruments, which had fair values of \$(0.4) million and \$(5.7) million, at March 31, 2009 and December 31, 2008, respectively. The Company recorded \$6.8 million of realized and unrealized foreign exchange gains on these hedges during the three months ended March 31, 2009 and \$29.9 million of realized and unrealized foreign exchange losses on these hedges during the three months ended March 31, 2008.

Financial Condition, Liquidity and Capital Resources

Financial Condition

Our investment portfolio on a risk basis, at March 31, 2009, comprised 94.4% fixed maturities, short-term investments and cash and cash equivalents, 0.5% equities and the balance in other investments. We believe our investments can be liquidated and converted into cash within a very short period of time. However, our investments in investment funds and catastrophe bonds, which represent 2.7% of our total investments and cash and cash equivalents at March 31, 2009, do not trade on liquid markets or are subject to redemption provisions that prevent us from converting them into cash immediately.

At March 31, 2009, all of our fixed maturity securities, with the exception of two securities with a fair value of less than \$0.4 million, were rated investment-grade (BBB- or higher) by Standard & Poor's (or estimated equivalent) with an average rating of AA+. At December 31, 2008, all of our fixed maturity securities, with the exception of \$0.3 million, were rated investment-grade (BBB- or higher) by Standard & Poor's (or estimated equivalent) with an average rating of AA+.

At March 31, 2009, and December 31, 2008, the average duration of the Company's investment portfolio was 2.7 years and 2.9 years, respectively. The duration decreased mostly due to the implementation of a change in asset allocation during the quarter that was approved by the Board.

At March 31, 2009 and December 31, 2008, we had no exposure to sub-prime backed investments or collateralized debt obligations ("CDOs") of sub-prime backed investments. At March 31, 2009 and December 31, 2008, our holdings of Alt -A securities were \$2.6 million with an average rating of AA+ and \$3.0 million with an average rating of AA+.

respectively. Alt – A securities are defined as a classification of mortgages where the risk profile falls between prime and sub-prime. The borrowers behind these mortgages will typically have clean credit histories, but the mortgage itself will generally have some features that increase its risk profile compared to prime securities, but less risky than sub-prime backed investments. These features include higher loan-to-value and debt-to-income ratios or inadequate documentation of the borrower’s income. Our exposure to traditional monoline insurers emanates from our non sub-prime asset-backed holdings. We did not hold securities with credit enhancement from the traditional monoline insurers at March 31, 2009 and we had \$1.2 million as of December 31, 2008. We do not have any collateralized loan obligations or CDO exposures in our portfolio.

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At March 31, 2009, our total of investments, cash and cash equivalents, and restricted cash was \$1.8 billion, compared to \$1.7 billion at December 31, 2008. The major factors influencing the movement in the three month period ended March 31, 2009, were as follows;

- Net investment loss of \$1.8 million
- Total net realized and unrealized gains on investments and other of \$5.5 million
 - Dividends paid of \$3.5 million
- Cash contributions into the portfolios from underwriting activities

Other investments as at March 31, 2009 amounted to \$52.3 million compared to \$54.7 million at December 31, 2008. The March 31, 2009 investments are comprised mainly of our investment in catastrophe bonds of \$39.2 million, in private equity and hedge funds of \$7.8 million and the Company's \$5.3 million equity investment. The decrease in other investments during the first three months of 2009 is principally related to a \$2.0 million decrease in the value of the private equity and hedge funds. Other investments are recorded at fair value with the exception of our equity investment. The Company retains some of its exposure to equity and real estate markets through the use of derivatives such as equity futures. These derivatives seek investment results which generally correspond to the price and yield performance of the underlying markets. As at March 31, 2009, the fair value of the equity futures derivatives held by the Company was \$3.0 million, compared to \$0.1 million as at December 31, 2008.

The net payable for investments purchased at March 31, 2009 was \$14.2 million, compared to a net receivable for investments sold \$1.9 million at December 31, 2008. Net payables and receivables for investments are a result of timing differences only, as investments are accounted for on a trade date basis.

Following the significant level of gross premiums written during the three months ended March 31, 2009, our insurance and reinsurance premium balances receivable, deferred acquisition costs and unearned premiums increased by \$145.1 million, \$15.4 million and \$150.3 million, respectively, over those balances at December 31, 2008.

At March 31, 2009, we had \$429.8 million of loss and loss adjustment expense reserves, compared to \$411.6 million at December 31, 2008. This increase of \$18.2 million is due to reserve additions of \$70.4 million for the first three months which includes 2009 catastrophe events, offset by paid losses of \$52.2 million. Of the balance at March 31, 2009, \$239.3 million, or 55.7%, represented incurred but not reported reserves.

At March 31, 2009, Flagstone's shareholders' equity was \$1,024.1 million, compared to \$986.0 million at December 31, 2008. The increase in Flagstone's shareholders' equity is primarily due to the net income attributable to Flagstone realized by the Company in the three months ended March 31, 2009.

Liquidity

Cash flows from operations for the three months ended March 31, 2009 decreased to \$73.1 million from \$105.8 million as compared to the same period in 2008. This decrease in cash flows from operations was primarily related to increased premium receivable and unearned premium ceded balances partially offset by an increase in unearned premiums and insurance and reinsurance balances payable. Because a large portion of the coverages we provide typically can produce losses of high severity and low frequency, it is not possible to accurately predict our future cash flows from operating activities. As a consequence, cash flows from operating activities may fluctuate, perhaps significantly, between individual quarters and years.

Cash flows relating to financing activities include the payment of dividends, share related transactions and the issuance or repayment of debt. During the three months ended March 31, 2009, net cash of \$3.9 million was used in financing activities, compared to \$10.1 million used in financing activities for the three months ended March 31, 2008. In the first three months of 2009, the net cash used in financing activities related principally to the payment of dividends and the repayment of debt. In the first quarter of 2008, the net cash provided by financing activities related principally to the payment of dividends and the redemption of preferred shares in Mont Fort ILW2.

We may incur additional indebtedness in the future if we determine that it would be an efficient part of our capital structure.

Generally, positive cash flows from our operating and financing activities are invested in the Company's investment portfolio.

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For the period from October 2005 until March 31, 2009, we have had sufficient cash flows from operations to meet our liquidity requirements. We expect that our operational needs for liquidity for at least the next twelve months will be met by our balance of cash, funds generated from underwriting activities, investment income and the proceeds from sales and maturities of our investment portfolio. The Company may require additional capital in the near term, whether through letters of credit or otherwise. Due to the current financial market crisis, it may be difficult for the insurance industry generally, and the Company in particular, to raise additional capital when required, on acceptable terms or at all. Cash and cash equivalents were \$604.0 million at March 31, 2009.

Capital Resources

Our total capital resources at March 31, 2009 and December 31, 2008 were as follows:

| | As at March 31, 2009 | As at December 31, 2008 |
|--|-------------------------|-------------------------------|
| Long term debt | \$ 265,306 | \$ 252,575 |
| Common shares | 849 | 848 |
| Additional paid-in capital | 901,344 | 897,344 |
| Accumulated other comprehensive income | (6,377) | (8,271) |
| Retained earnings | 128,307 | 96,092 |
| Total capitalization | \$ 1,289,429 | \$ 1,238,588 |

The change in the amount of the long term debt at March 31, 2009 compared to December 31, 2008 is primarily due to the acquisition of IAL 7X. Refer to Note 13 "Related Party Transactions" of the unaudited condensed consolidated financial statements for a more detailed discussion.

The movement in additional paid-in capital primarily arises from \$4.0 million of stock based compensation for the three months ended March 31, 2009.

Letter of Credit Facilities

Under the terms of certain reinsurance contracts, our reinsurance subsidiaries may be required to provide letters of credit to reinsureds in respect of reported claims and/or unearned premiums. On January 22, 2009, Flagstone Suisse entered into a secured \$450.0 million standby letter of credit facility with Citibank Europe Plc. The facility comprises a \$300.0 million facility for letters of credit with a maximum tenor of 15 months and a \$150.0 million facility for letters of credit issued in respect of Funds at Lloyds with a maximum tenor of 60 months, in each case subject to automatic extension for successive periods, but in no event longer than one year. The facility will be used to support the reinsurance obligations of the Company and its subsidiaries. As at March 31, 2009, \$324.5 million had been drawn under this facility, and the drawn amount of the facility was secured by \$360.5 million of fixed maturity securities from the Company's investment portfolio. During 2008, the Company had a \$400.0 million uncommitted letter of credit facility agreement with Citibank N.A. As at December 31, 2008, \$285.7 million had been drawn under this facility, and the drawn amount of the facility was secured by \$327.2 million of fixed maturity securities from the Company's investment portfolio. This facility was replaced by the above noted \$450 million facility.

In September 2007, the Company entered into a \$200.0 million uncommitted letter of credit facility agreement with Wachovia. Flagstone Reinsurance Limited had not drawn upon this facility as at March 31, 2009. Wachovia and the

Company are currently engaged in negotiations to potentially amend or revise the facility to accommodate the restructuring of the Company's global reinsurance operations which occurred on September 30, 2008.

On March 5, 2009, Flagstone Suisse entered into a \$200.0 million secured committed letter of credit facility with Barclays Bank Plc (the "Facility"). The Facility will be used to support the reinsurance obligations of the Company and its subsidiaries. As at March 31, 2009, there were no letters of credit issued under the facility.

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Restrictions and Specific Requirements

Flagstone Suisse is licensed to operate as a reinsurer in Switzerland and is also licensed in Bermuda through the Flagstone Suisse branch office and is not licensed in any other jurisdictions. Because many jurisdictions do not permit insurance companies to take credit for reinsurance obtained from unlicensed or non-admitted insurers on their statutory financial statements unless appropriate security mechanisms are in place, we anticipate that our reinsurance clients will typically require Flagstone Suisse to post a letter of credit or other collateral.

Swiss law permits dividends to be declared only after profits have been allocated to the reserves required by law and to any reserves required by the articles of incorporation. The articles of incorporation of Flagstone Suisse do not require any specific reserves. Therefore, Flagstone Suisse must allocate any profits first to the reserve required by Swiss law generally, and may pay as dividends only the balance of the profits remaining after that allocation. In the case of Flagstone Suisse, Swiss law requires that 20% of the company's profits be allocated to a "general reserve" until the reserve reaches 50% of its paid-in share capital.

In addition, a Swiss reinsurance company may pay a dividend only if, after payment of the dividend, it will continue to comply with regulatory requirements regarding minimum capital, special reserves and solvency requirements.

The Bermuda Insurance Act requires Flagstone Suisse to maintain a minimum solvency margin (being the minimum amount that the statutory assets must exceed the statutory liabilities as required by the Bermuda Insurance Act) equal to the greatest of (i) \$100 million, (ii) 50% of net premiums written or (iii) 15% of the reserve for losses and loss adjustment expenses. Bermuda law limits the maximum amount of annual dividends or distributions payable by Flagstone Suisse to the Company and in certain cases requires the prior notification to, or the approval of, the BMA. As a Bermuda Class 4 reinsurer, Flagstone Suisse may not pay dividends in any financial year which would exceed 25% of its total statutory capital and surplus unless at least seven days before payment of those dividends it files an affidavit with the BMA signed by at least two directors and Flagstone Suisse's principal representative, which states that in their opinion, declaration of those dividends will not cause Flagstone Suisse to fail to meet its prescribed solvency margin and liquidity ratio. Further, Flagstone Suisse may not reduce by 15% or more its total statutory capital as set out in its previous year's statements, without the prior approval of the BMA. Flagstone Suisse must also maintain, as a Class 4 Bermuda reinsurer, paid-up share capital of \$1 million.

Island Heritage is domiciled in the Cayman Islands and maintains a Class A Domestic Insurance License issued in accordance with the terms of the Insurance Law (as revised) of the Cayman Islands, or the Law, and is subject to regulation by the Cayman Islands Monetary Authority ("CIMA") in terms of the Law. Island Heritage is required to maintain a net worth (defined in the Law as the excess of assets, including any contingent or reserve fund secured to the satisfaction of CIMA, over liabilities other than liabilities to partners or shareholders) of at least 100,000 Cayman Islands dollars (which is equal to approximately U.S. \$120,000), subject to increase by CIMA depending on the type of business undertaken. In addition Island Heritage may not issue any dividends without prior approval from the Cayman Islands Monetary Authority. In order to obtain approval Island Heritage must demonstrate that the issuing of dividends would not render Island Heritage insolvent or affect its ability to pay any future claims.

Flagstone Africa is licensed to operate as a reinsurer in South Africa and is subject to statutory minimum capital requirements under applicable legislation. In addition, a South African reinsurance company may pay a dividend only if, after payment of the dividend, it will continue to comply with regulatory requirements regarding minimum capital, special reserves and solvency requirements.

Flagstone Alliance operates under license issued by the Cyprus Insurance Superintendent to conduct general reinsurance and insurance business. Cyprus Companies Law permits dividends to be declared only if there are available sufficient distributable reserves after profits have been allocated to the reserves required by law and to any reserves required by the articles of incorporation. The articles of incorporation of Flagstone Alliance do not require any specific reserves. Irrespective of the Cyprus Companies Law, Cap 113 requirements and the Flagstone Alliance's articles of association, Flagstone Alliance should maintain at any time, reserves and assets that meet the Solvency criteria and Orders of the Cyprus Insurance Superintendent. Flagstone Alliance complies and reports to the Superintendent of Insurance under Solvency I requirements and the Solvency II requirements will be adopted in 2012. Revenue reserves are distributable to the extent permitted by the Companies Law, and Flagstone Alliance's Articles of Association. The share premium account cannot be used for the distribution of dividends but can be used to issue bonus shares. The reserve arising on the conversion of share capital to Euro may be capitalized by way of a future capital increase; alternatively, Flagstone Alliance may decide at a shareholders' general meeting to distribute the decrease by way of a dividend.

The financial services industry in the United Kingdom is regulated by the Financial Services Authority ("FSA"). The FSA is an independent non-governmental body, given statutory powers by the Financial Services and Markets Act 2000. Although accountable to treasury ministers and through them to Parliament, it is funded entirely by the firms it regulates. The FSA has wide ranging powers in relation to rule-making, investigation and enforcement to enable it to meet its four statutory objectives, which are summarized as one overall aim: "to promote efficient, orderly and fair markets and to help retail consumers achieve a fair deal".

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In relation to insurance business, the FSA regulates insurers, insurance intermediaries and Lloyd's itself. The FSA and Lloyd's have common objectives in ensuring that Lloyd's market is appropriately regulated and, to minimize duplication, the FSA has agreed arrangements with Lloyd's for co-operation on supervision and enforcement.

Marlborough's underwriting activities are therefore regulated by the FSA as well as being subject to the Lloyd's "franchise". Both FSA and Lloyd's have powers to remove their respective authorization to manage Lloyd's syndicates. Lloyd's approves annually Syndicate 1861's business plan and any subsequent material changes, and the amount of capital required to support that plan. Lloyd's may require changes to any business plan presented to it or additional capital to be provided to support the underwriting (known as Funds at Lloyd's).

Off Balance Sheet Arrangements

Mont Gele is a special purpose Cayman Islands exempted company licensed as a restricted Class B reinsurer in the Cayman Islands and formed solely for the purpose of entering into certain reinsurance agreements and other risk transfer agreements with Flagstone Suisse. We have entered into an excess of loss reinsurance agreement with Mont Gele that provides us with a \$60.0 million limit.

The Company has determined that Mont Gele has the characteristics of a variable interest entity that are addressed by FASB Interpretation No. 46R "Consolidation of Variable Interest Entities" ("FIN 46R"). In accordance with FIN 46R, Mont Gele is not consolidated because the Company is not the primary beneficiary.

Valais Re is a special purpose Cayman Islands exempted company licensed as a restricted Class B reinsurer in the Cayman Islands and formed solely for the purpose of entering into certain reinsurance agreements and other risk transfer agreements with subsidiaries of Flagstone Suisse. We have entered into a reinsurance agreement with Valais Re that provides us with \$104.0 million of aggregate indemnity protection for certain losses from global catastrophe events.

The Company has determined that Valais Re has the characteristics of a variable interest entity that are addressed by FASB Interpretation No. 46R "Consolidation of Variable Interest Entities" ("FIN 46R"). In accordance with FIN 46R, Valais Re is not consolidated because the Company is not the primary beneficiary.

We are not party to any transaction, agreement or other contractual arrangement to which an affiliated entity unconsolidated with us is a party, other than that noted above with Mont Gele and Valais Re, that management believes is reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

For details relating to our letter of credit facilities see "Financial Condition, Liquidity and Capital Resources - Financial Condition – Letter of Credit Facilities".

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

We measure and manage market risks and other risks as part of a company-wide risk management process. The market risks described in this section relate to financial instruments, primarily in our investment portfolio, that are sensitive to changes in interest rates, credit risk premiums or spreads, foreign exchange rates and equity prices.

We believe that we are currently principally exposed to four types of market risk: interest rate risk, equity price risk, credit risk and foreign currency risk.

Interest Rate Risk

Our primary market risk exposure is to changes in interest rates. Our fixed maturity portfolio is exposed to interest rate risk. Fluctuations in interest rates have a direct impact on the market valuation of these investments. As interest rates rise, the market value of our fixed maturity portfolio falls and we have the risk that cash outflows will have to be funded by selling assets, which will be trading at depreciated values. As interest rates decline, the market value of our fixed income portfolio increases and we have reinvestment risk, as funds reinvested will earn less than is necessary to match anticipated liabilities. We expect to manage interest rate risk by selecting investments with characteristics such as duration, yield, currency and liquidity tailored to the anticipated cash outflow characteristics of the reinsurance liabilities of the Company. In addition, from time-to-time, the Company may enter into interest rate swap contracts as protection against unexpected shifts in interest rates, which would affect the fair value of the fixed maturity portfolio. By using swaps in the portfolio, the overall duration or interest rate sensitivity of the portfolio can be altered.

As at March 31, 2009, the impact on our fixed maturity securities, cash and cash equivalents, from an immediate 100 basis point increase in market interest rates would have resulted in an estimated decrease in market value of 2.7%, or approximately \$41.2 million. As at March 31, 2009, the impact on our fixed maturity securities, cash and cash equivalents, from an immediate 100 basis point decrease in market interest rates would have resulted in an estimated increase in market value of 2.6%, or approximately \$40.0 million.

As at March 31, 2009, we held \$116.8 million, or 10.9%, of our fixed maturity portfolio in asset-backed and mortgage-backed securities. We did not hold any sub-prime securities at March 31, 2009. These assets are exposed to prepayment risk, which occurs when holders of underlying loans increase the frequency with which they prepay the outstanding principal before the maturity date and refinance at a lower interest rate cost. The adverse impact of prepayment is more evident in a declining interest rate environment. As a result, the Company will be exposed to reinvestment risk, as cash flows received by the Company could be accelerated and will be reinvested at the prevailing interest rates.

Equity Price Risk

We gain exposure to the equity, commodities and real estate markets through the use of various equity securities, index-linked futures, exchange traded funds and investment funds. The total of such exposure as of March 31, 2009 was \$47.4 million. However, from a fair value perspective, futures are valued for only the unrealized gains and losses, but not for the exposure. As a result, the fair value of these positions as at March 31, 2009 amounted to \$5.8 million and was recorded in both equities and other investments with net realized and unrealized losses of \$12.9 million for the three months ended March 31, 2009, recorded in net realized and unrealized losses - investments. The total

exposure of the index-linked futures was \$44.6 million as at March 31, 2009.

Credit Risk

The Company has exposure to credit risk primarily as a holder of fixed maturity securities. Our risk management strategy and investment guidelines have been defined to ensure we invest in debt instruments of high credit quality issuers and to limit the amount of credit exposure with respect to particular ratings categories and any one issuer. As at March 31, 2009, the majority of our fixed maturity investments consisted of investment grade securities with an average rating of AA+. The Company believes this high-quality portfolio reduces its exposure to credit risk on fixed income investments to an acceptable level.

The Company does not have any exposure to credit risk as a holder of sub-prime backed investments. The Company does not allow sub-prime investment by any investment manager. At March 31, 2009, we held \$2.6 million of Alt-A securities with an average rating of AA+, including one security valued at less than \$0.1 million with a rating of CC.

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The Company is operating in an investment climate that is characterized by significant uncertainty and resultant market volatility. The recent failure of large financial institutions in the United States has exacerbated the uncertainty. The Company has carefully analyzed its exposure to the recent market turmoil, and based on its analysis has concluded that it does not have significant direct exposure to Lehman Brothers, American International Group Inc. (“AIG”), Federal National Mortgage Association (“Fannie Mae”), Federal Home Loan Mortgage Corporation (“Freddie Mac”) or Madoff funds; however the indirect impact of such significant business failures is difficult to determine and the Company will continue to monitor market developments as they occur.

To a lesser extent, the Company also has credit risk exposure as a party to over-the-counter derivative instruments. To mitigate this risk, we monitor our exposure by counterparty and ensure that counterparties to these contracts are high-credit-quality international banks or counterparties. These derivative instruments include foreign currency forwards contracts, currency swaps, interest rate swaps and total return swaps.

In addition, the Company has exposure to credit risk as it relates to its trade balances receivable, namely insurance and reinsurance balances receivable. Insurance and reinsurance balances receivable from the Company’s clients at March 31, 2009 and December 31, 2008, were \$363.4 million and \$218.3 million, respectively, including balances both currently due and accrued. The Company believes that credit risk exposure related to these balances is mitigated by several factors, including but not limited to credit checks performed as part of the underwriting process, monitoring of aged receivable balances, our right to cancel the cover for non-payment of premiums, and our right to offset premiums yet to be paid against losses due to the cedent. Since our inception in October 2005, we have recorded \$1.8 million in bad debt expenses related to its insurance and reinsurance balances receivable.

The Company purchases retrocessional reinsurance and we require our reinsurers to have adequate financial strength. The Company evaluates the financial condition of its reinsurers and monitors its concentration of credit risk on an ongoing basis.

In addition, consistent with industry practice, we assume a degree of credit risk associated with reinsurance and insurance brokers. We frequently pay amounts owed on claims under our policies to reinsurance brokers, and these brokers, in turn, pay these amounts to the ceding insurers that have reinsured a portion of their liabilities with us. In some jurisdictions, if a broker fails to make such a payment, we may remain liable to the ceding insurer for the deficiency. Conversely, in certain jurisdictions, when the ceding insurer pays premiums to reinsurance brokers for payment to us, these premiums are considered to have been paid and the ceding insurer will no longer be liable to us for those amounts, regardless of whether we have received the premiums.

For risk management purposes, we use catastrophe bonds to manage our reinsurance risk and treat the catastrophe risks related to catastrophe bonds as part of the underwriting risks of the Company. Catastrophe bonds are selected by our reinsurance underwriters however they are held in our investment portfolio as low risk floating rate bonds. We believe that amalgamating the catastrophe risk in the catastrophe bonds with our other reinsurance risks produces more meaningful risk management reporting.

Foreign Currency Risk

Premiums, Reserves, and Claims

The U.S. dollar is our principal reporting currency and the functional currencies of our operating subsidiaries are generally their national currencies, except for our Bermuda, Cayman Islands, Luxembourg, Gibraltar and Marlborough subsidiaries and the Bermuda branch of Flagstone Suisse, whose functional currency, following the September 30, 2008 restructuring, is the U.S. dollar. We enter into reinsurance contracts where the premiums receivable and losses payable are denominated in currencies other than the U.S. dollar. When we incur a loss in a non-U.S. dollar currency, we carry the liability on our books in the original currency. As a result, we have an exposure to foreign currency risk resulting from fluctuations in exchange rates between the time premiums are collected and converted to the functional currency (either U.S. dollars, Swiss franc, Euro, Great Britain pound or South African rand), and the time claims are paid.

With respect to loss reserves denominated in non-U.S. dollar currencies, our policy is to hedge our non-U.S. dollar foreign currency exposure with forward foreign exchange purchases. Expected losses means incurred and reported losses and incurred but not reported losses. We do not hedge future catastrophe events. However, upon the occurrence of a catastrophe loss and when the actuarial department has estimated the non-U.S. dollar loss to the Company, we purchase foreign currency promptly on a forward basis. When we pay claims in a non-base currency, we either use the proceeds of a foreign currency forward contract to do so, or buy spot foreign exchange to pay the claim and simultaneously adjust the hedge balance to the new lower exposure.

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Investments

The majority of the securities held in our investment portfolios are measured in U.S. dollars, with a portion of our fixed maturities portfolio invested in non-U.S. dollar currencies. At the time of purchase, each investment is identified as either a hedged investment, to be maintained with an appropriate currency hedge to U.S. dollars or an unhedged investment, one not to be maintained with a hedge. Generally, fixed income investments will be hedged, listed equity investments may or may not be hedged, and other investments such as real estate and commodities will not be hedged.

Financing

When the Company or its subsidiaries issues a debt or equity financing in a currency other than the functional currency of that company, our practice is to hedge that exposure. The net contractual amount of these contracts as at March 31, 2009 and December 31, 2008 was \$436.6 million and \$432.4 million, respectively, and these contracts had a fair value of \$(4.6) million and \$(9.5) million, respectively. During the three months ended March 31, 2009, the Company recorded \$4.5 million of realized and unrealized gains on foreign currency forward contracts and for the three months ended March 31, 2008, the Company recorded \$5.6 million of realized and unrealized losses on foreign currency forward contracts. The Company designated \$181.8 million foreign currency forwards with notional contractual value as hedging instruments, which had a fair value of \$(0.4) million as of March 31, 2009. During the three months ended March 31, 2009, the Company recorded \$6.8 million of realized and unrealized gains directly into comprehensive income as part of the cumulative translation adjustment for the effective portion of the hedge. The Company designated \$337.7 million foreign currency forwards with notional contractual value as hedging instruments, which had a fair value of \$(5.7) million as of December 31, 2008. During the three months ended March 31, 2008, the Company recorded \$29.9 million of realized and unrealized losses directly into comprehensive income as part of the cumulative translation adjustment for the effective portion of the hedge.

The Company entered into a currency swap agreement to hedge the Euro-denominated Deferrable Interest Debentures recorded as long term debt. Under the terms of the foreign currency swap, the Company exchanged €13.0 million for \$18.4 million, will receive Euribor plus 354 basis points and pay LIBOR plus 367 basis points. The swap expires on September 15, 2011 and had a fair value of \$(1.1) million as at March 31, 2009.

Foreign currency exchange contracts will not eliminate fluctuations in the value of our assets and liabilities denominated in foreign currencies but rather allow us to establish a rate of exchange for a future point in time. Of our business written in the three month periods ended March 31, 2009 and 2008, approximately 38.0% and 46.0%, respectively, was written in currencies other than the U.S. dollar. For the three months ended March 31, 2009, we had net realized and unrealized foreign exchange losses of \$1.1 million compared to foreign exchange gains of \$6.7 million for the same period in 2008.

The Company does not hedge currencies for which its asset or liability exposures are not material or where it is unable or impractical to do so. In such cases, the Company is exposed to foreign currency risk. However, the Company does not believe that the foreign currency risks corresponding to these unhedged positions are material.

Effects of Inflation

We do not believe that inflation has had a material effect on our combined results of operations, except insofar as inflation may affect interest rates.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Form 10-Q contains, and the Company may from time to time make, written or oral “forward-looking statements” within the meaning of the U.S. federal securities laws, which are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. All forward-looking statements rely on a number of assumptions concerning future events and are subject to a number of uncertainties and other factors, many of which are outside the Company’s control, that could cause actual results to differ materially from such statements. In particular, statements using words such as “may”, “should”, “estimate”, “expect”, “anticipate”, “intend”, “believe”, “predict”, “potential”, or words that import generally involve forward-looking statements.

Important events and uncertainties that could cause the actual results to differ include, but are not necessarily limited to: market conditions affecting the Company’s common share price; the impact of the current unprecedented volatility in the financial markets, including the duration of the economic crisis and the effectiveness of governmental solutions; the weakening economy, including the impact on our consumers’ businesses; fluctuations in interest rates; the effects of corporate bankruptcies on capital markets; the possibility of severe or unanticipated losses from natural or man-made catastrophes; the effectiveness of our loss limitation methods; our dependence on principal employees; the cyclical nature of the insurance and reinsurance business; the levels of new and renewal business achieved; opportunities to increase writings in our core property and specialty reinsurance and insurance lines of business and in specific areas of the casualty reinsurance market; the sensitivity of our business to financial strength ratings established by independent rating agencies; the estimates reported by cedents and brokers on pro-rata contracts and certain excess of loss contracts where the deposit premium is not specified in the contract; the inherent uncertainties of establishing reserves for loss and loss adjustment expenses, our reliance on industry loss estimates and those generated by modeling techniques; unanticipated adjustments to premium estimates; changes in the availability, cost or quality of reinsurance or retrocessional coverage; changes in general economic conditions; changes in governmental regulation or tax laws in the jurisdictions where we conduct business; the amount and timing of reinsurance recoverables and reimbursements we actually receive from our reinsurers; the overall level of competition, and the related demand and supply dynamics in our markets relating to growing capital levels in the insurance and reinsurance industries; declining demand due to increased retentions by cedents and other factors; the impact of terrorist activities on the economy; and rating agency policies and practices.

These and other events that could cause actual results to differ are discussed in more detail from time to time in our filings with the SEC. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by U.S. federal securities laws. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date on which they are made.

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Item 4. Controls and Procedures

Disclosure Controls and Procedures

As of the end of the period covered by this report, our management has performed an evaluation pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934 (the “Exchange Act”), with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Disclosure controls and procedures are designed to ensure that information required to be disclosed in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by SEC rules and forms and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow for timely decisions regarding required disclosures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered in this report, our company’s disclosure controls and procedures were effective.

Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during our first fiscal quarter of 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

NONE

Item 1A. Risk Factors

There have been no material changes to the risk factors previously described in Part I, Item 1A of our annual report on Form 10-K for the fiscal year ended December 31, 2008.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

NONE

Item 3. Defaults upon Senior Securities

NONE

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

NONE

Item 5. Other Information

NONE

Item 6. Exhibits

The exhibits listed on the accompanying Exhibit Index, and such Exhibit Index, are filed or incorporated by reference as a part of this report.

SIGNATURES

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

Dated: May 8, 2009

FLAGSTONE REINSURANCE HOLDINGS
LIMITED

By: /s/ David Brown
David Brown
Chief Executive Officer

(Authorized Officer)

By: /s/ Patrick Boisvert
Patrick Boisvert
Chief Financial Officer

(Principal Financial Officer)

EXHIBIT INDEX

Pursuant to Item 601 of Regulation S-K

| Exhibit No. | Description of Exhibit |
|-------------|---|
| 31.1 | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, with respect to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2009. |
| 31.2 | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, with respect to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2009. |
| 32.1 | Certification of Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, with respect to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2009. |
| 32.2 | Certification of Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, with respect to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2009. |