

Flagstone Reinsurance Holdings, S.A.  
Form 10-Q  
August 07, 2012

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

Form 10-Q

Quarterly Report Pursuant to Section 13 or 15(d)  
of the Securities Exchange Act of 1934  
For the quarterly period ended June 30, 2012

OR

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

Commission file number 001-33364  
Flagstone Reinsurance Holdings, S.A.  
(Exact name of registrant as specified in its charter)

Luxembourg  
(State or Other Jurisdiction of  
Incorporation or Organization)

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

65 Avenue de la Gare  
L-1611 Luxembourg, Grand Duchy of Luxembourg  
(Address of principal executive offices)

+352 273 515 30  
(Registrant's telephone number, including area code)

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

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

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

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 August 7, 2012, the Registrant had 71,058,922 common voting shares outstanding, net of treasury shares with a par value of \$0.01 per share.

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements

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

	As at June 30, 2012	As at December 31, 2011
<b>ASSETS</b>		
Investments:		
Fixed maturity investments, at fair value (Amortized cost: 2012 - \$342,491; 2011 - \$1,135,755)	\$ 333,674	\$ 1,138,435
Short term investments, at fair value (Amortized cost: 2012 - \$696,837; 2011 - \$10,620)	696,838	10,616
Equity investments, at fair value (Amortized cost: 2012 - \$236; 2011 - \$245)	61	82
Other investments	142,443	125,452
<b>Total investments</b>	<b>1,173,016</b>	<b>1,274,585</b>
Cash and cash equivalents	186,251	249,424
Restricted cash	17,823	17,538
Premium balances receivable	273,744	236,375
Unearned premiums ceded	58,679	30,550
Reinsurance recoverable	232,784	271,183
Accrued interest receivable	2,607	12,950
Receivable for investments sold	2,435	18
Deferred acquisition costs	50,144	38,155
Funds withheld	25,983	25,116
Other assets	110,919	160,950
Assets held for sale including discontinued operations	439,641	461,652
<b>Total assets</b>	<b>\$ 2,574,026</b>	<b>\$ 2,778,496</b>
<b>LIABILITIES</b>		
Loss and loss adjustment expense reserves	\$ 682,329	\$ 897,368
Unearned premiums	292,109	215,316
Insurance and reinsurance balances payable	45,454	75,433
Payable for investments purchased	2,494	6,255
Long term debt	250,202	250,575
Other liabilities	70,964	54,059
Liabilities of discontinued operations held for sale	393,814	472,957
<b>Total liabilities</b>	<b>1,737,366</b>	<b>1,971,963</b>
<b>EQUITY</b>		
Common voting shares, 300,000,000 authorized, \$0.01 par value, issued (2012 - 84,464,259; 2011 - 84,464,259) and outstanding (2012 - 71,058,922; 2011 - 70,167,142)	845	845
Common shares held in treasury, at cost (2012 - 13,405,337; 2011 - 14,297,117)	(150,202)	(160,448)

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Additional paid-in capital	857,714	872,819
Accumulated other comprehensive loss	(12,788)	(12,584)
Retained earnings	141,091	88,416
Total Flagstone shareholders' equity	836,660	789,048
Noncontrolling interest in subsidiaries	-	17,485
Total equity	836,660	806,533
Total liabilities and equity	\$ 2,574,026	\$ 2,778,496

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, S.A.  
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 AND COMPREHENSIVE INCOME (LOSS)  
 (Expressed in thousands of U.S. dollars, except share and per share data)

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
<b>REVENUES</b>				
Gross premiums written	\$ 171,150	\$ 264,128	\$ 341,378	\$ 616,803
Premiums ceded	(6,285)	(44,409)	(91,184)	(163,159)
Net premiums written	164,865	219,719	250,194	453,644
Change in net unearned premiums	(62,366)	(101,099)	(33,950)	(133,971)
Net premiums earned	102,499	118,620	216,244	319,673
Net investment income	3,866	12,300	8,933	21,498
Net realized and unrealized gains (losses) - investments	5,365	(7,905)	23,468	2,866
Net realized and unrealized (losses) gains - other	(4,990)	13,986	1,393	13,296
Other income	1,546	1,554	4,357	2,686
Total revenues	108,286	138,555	254,395	360,019
<b>EXPENSES</b>				
Loss and loss adjustment expenses	55,483	96,490	121,932	399,489
Acquisition costs	22,113	25,613	44,766	63,684
General and administrative expenses	18,822	19,744	40,682	35,819
Interest expense	2,965	2,892	5,923	5,742
Net foreign exchange (gains) losses	(3,354)	27,445	877	37,048
Total expenses	96,029	172,184	214,180	541,782
Income (loss) from continuing operations before income taxes and interest in earnings of equity investments	12,257	(33,629)	40,215	(181,763)
(Provision) recovery for income tax	(185)	827	(313)	1,073
Interest in earnings of equity investments	270	(171)	288	(456)
Income (loss) from continuing operations	12,342	(32,973)	40,190	(181,146)
Income from discontinued operations, net of taxes	1,148	13,960	13,620	1,737
Net income (loss)	13,490	(19,013)	53,810	(179,409)
Less: Income attributable to noncontrolling interest	-	(1,197)	(1,135)	(2,021)
<b>NET INCOME (LOSS)</b>				
<b>ATTRIBUTABLE TO FLAGSTONE</b>	\$ 13,490	\$ (20,210)	\$ 52,675	\$ (181,430)
Net income (loss)	\$ 13,490	\$ (19,013)	\$ 53,810	\$ (179,409)
	(4,669)	873	(132)	3,750

Change in currency translation adjustment				
Change in defined benefit pension plan obligation	136	(158)	(72)	(158)
Comprehensive income (loss)	8,957	(18,298)	53,606	(175,817)
Less: Comprehensive income attributable to noncontrolling interest	-	(1,197)	(1,135)	(2,021)
<b>COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO FLAGSTONE</b>	<b>\$ 8,957</b>	<b>\$ (19,495)</b>	<b>\$ 52,471</b>	<b>\$ (177,838)</b>
Weighted average common shares outstanding—Basic	71,352,487	70,380,852	71,015,712	69,869,195
Weighted average common shares outstanding—Diluted	71,763,904	70,380,852	71,572,129	69,869,195
Income (loss) from continuing operations per common share—Basic	\$ 0.17	\$ (0.49)	\$ 0.55	\$ (2.62)
Income from discontinued operations per common share—Basic	\$ 0.02	\$ 0.20	\$ 0.19	\$ 0.02
Net income (loss) attributable to Flagstone per common share—Basic	\$ 0.19	\$ (0.29)	\$ 0.74	\$ (2.60)
Income (loss) from continuing operations per common share—Diluted	\$ 0.17	\$ (0.49)	\$ 0.55	\$ (2.62)
Income from discontinued operations per common share—Diluted	\$ 0.02	\$ 0.20	\$ 0.19	\$ 0.02
Net income (loss) attributable to Flagstone per common share—Diluted	\$ 0.19	\$ (0.29)	\$ 0.74	\$ (2.60)
Distributions declared per common share	\$ 0.04	\$ 0.04	\$ 0.08	\$ 0.08

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, S.A.  
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY  
 (Expressed in thousands of U.S. dollars)

For the six months ended June 30, 2012	Total equity	Retained earnings	Flagstone Shareholders' Equity				Additional paid-in capital	Noncontrolling interest in subsidiaries
			Accumulated other comprehensive loss	Common voting shares	Treasury shares			
Beginning balance	\$ 806,533	\$ 88,416	\$ (12,584)	\$ 845	\$ (160,448)	\$ 872,819	\$ 17,485	
Disposal of discontinued operations	(18,620)						(18,620)	
Net income	53,810	52,675					1,135	
Change in currency translation adjustment	(132)		(132)					
Defined benefit pension plan obligation	(72)		(72)					
Stock based compensation	2,239					2,239		
Stock compensation exercised from treasury	-				10,246	(10,246)		
Distributions declared per common share	(5,684)					(5,684)		
Other	(1,414)					(1,414)		
Ending balance	\$ 836,660	\$ 141,091	\$ (12,788)	\$ 845	\$ (150,202)	\$ 857,714	\$ -	

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

For the six months ended June 30, 2011	Flagstone Shareholders' Equity						
	Total equity	Retained earnings	Accumulated other comprehensive loss	Common voting shares	Treasury shares	Additional paid-in capital	Noncontrolling interest in subsidiaries
Beginning balance	\$ 1,196,595	\$ 414,549	\$ (6,178)	\$ 845	\$ (178,718)	\$ 904,235	\$ 61,862
Redemption of preferred shares	(46,488)						(46,488)
Net loss	(179,409)	(181,430)					2,021
Change in currency translation adjustment	3,750		3,750				
Defined benefit pension plan obligation	(158)		(158)				
Stock based compensation	(2,573)					(2,573)	
Stock compensation exercised from treasury	-				17,017	(17,017)	
Distributions declared per common share	(5,604)					(5,604)	
Other	(1,814)					(1,814)	
Ending balance	\$ 964,299	\$ 233,119	\$ (2,586)	\$ 845	\$ (161,701)	\$ 877,227	\$ 17,395

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

For the six months ended June 30,

	2012	2011
Cash flows provided by (used in) operating activities:		
Net income (loss)	\$ 53,810	\$ (179,409)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Net realized and unrealized gains	(26,552)	(16,439)
Net unrealized foreign exchange (gains) losses	(9,228)	2,947
Depreciation and amortization expense	1,839	3,142
Share based compensation expense (recovery)	2,239	(2,573)
Interest in earnings of equity investments	(288)	456
Accretion/amortization on fixed maturity investments	2,522	(1,808)
Changes in assets and liabilities, excluding net assets acquired:		
Gain on sale of discontinued operations	(4,522)	-
Premium balances receivable	(60,932)	(212,208)
Unearned premiums ceded	(35,492)	(67,180)
Reinsurance recoverable	28,599	(152,094)
Deferred acquisition costs	(16,054)	(22,514)
Funds withheld	(870)	(4,780)
Loss and loss adjustment expense reserves	(200,673)	344,102
Unearned premiums	104,022	199,173
Insurance and reinsurance balances payable	(27,912)	44,411
Other changes in assets and liabilities, net	8,527	(30,467)
Net cash (used in) provided by operating activities	(180,965)	(95,241)
Cash flows (used in) provided by investing activities:		
Net cash received in disposal of subsidiaries	8,628	1,948
Purchases of fixed maturity investments	(1,209,342)	(520,808)
Sales and maturities of fixed maturity investments	1,338,513	661,901
Purchases of other investments	(10,650)	(17,907)
Sales and maturities of other investments	15,734	(28,767)
Purchases of fixed assets	(2,725)	(5,617)
Sales of fixed asset	1,194	-
Change in restricted cash	(61,208)	(11,323)
Net cash provided by investing activities	80,144	79,427

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Cash flows (used in) provided by financing activities:			
Repurchase of noncontrolling interest		-	(46,488)
Distributions paid per common share	(5,684)		(5,602)
Other	(1,290)		(179)
Net cash used in financing activities	(6,974)		(52,269)
Effect of foreign exchange rate on cash	712		(1,638)
Decrease in cash and cash equivalents	(107,083)		(69,721)
Decrease in cash and cash equivalents from discontinued operations	43,910		44,724
Cash and cash equivalents - beginning of year	249,424		223,033
Cash and cash equivalents - end of period	\$ 186,251	\$	198,036
Supplemental cash flow information:			
Receivable for investments sold	\$ 2,435	\$	203,257
Payable for investments purchased	\$ 2,494	\$	176,750
Interest paid	\$ 4,901	\$	2,358

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, S.A.  
NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Amounts in tables expressed in thousands of U.S. dollars, except for share amounts, per share amounts and percentages)

1. ORGANIZATION

Flagstone Reinsurance Holdings, S.A. (“Flagstone” or the “Company”) is a holding company incorporated as a société anonyme under the laws of Luxembourg. On May 14, 2010, the Company’s shareholders approved the redomestication to change the Company’s jurisdiction of incorporation from Bermuda to Luxembourg and the Company thereby discontinued its existence as a Bermuda company as provided in Section 132G of The Companies Act 1981 of Bermuda and continued its existence as a société anonyme under the laws of Luxembourg effective May 17, 2010 (the “Redomestication”). As a result of the Redomestication, the Company changed its name from Flagstone Reinsurance Holdings Limited to Flagstone Reinsurance Holdings, S.A. The Company was originally incorporated on October 4, 2005 under the laws of Bermuda.

On October 24, 2011, the Company announced its plans to undertake a number of strategic initiatives, including its decision to divest its ownership positions in its former Lloyd’s and Island Heritage reportable segments in order to address changing business conditions, refocus the Company’s underwriting strategy on its property catastrophe reinsurance business and reduce its focus on reportable segments that absorb capital and produce lower returns.

The Company has classified the assets and liabilities associated with its former Lloyd’s reportable segment as held for sale and the associated financial results have been presented in the Company’s consolidated financial statements as “discontinued operations” for all periods presented. The financial results of the Company’s former Island Heritage reportable segment have been presented in the Company’s consolidated financial statements as “discontinued operations” for all periods up to and including March 31, 2012. The sale of the former Island Heritage reportable segment was completed on April 5, 2012. See Note 4 “Assets Held for Sale and Discontinued Operations” for more information.

2. BASIS OF PRESENTATION AND CONSOLIDATION

These unaudited condensed consolidated financial statements include the accounts of Flagstone and its wholly owned subsidiaries, including Flagstone Réassurance Suisse S.A. (“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. References in this Quarterly Report on Form 10-Q (this “Quarterly Report”) to “dollars” or “\$” are to the lawful currency of the United States of America (the “U.S.”), 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, percentages or unless otherwise stated. References in this Quarterly Report to (i) “foreign currency” are to currencies other than U.S. dollars and (ii) “foreign exchange” transactions or “foreign investments” are to transactions or investments, respectively, involving currencies other than U.S. dollars, in each case unless the context otherwise requires. References in this Quarterly Report to “foreign subsidiaries” are to subsidiaries of Flagstone that are not domiciled in the U.S. or whose primary transactions are in foreign currency. 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 the Consolidation Topic of the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”). 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, except as otherwise required under discontinued operations treatment.

Except as discussed in Note 4 “Assets Held for Sale and Discontinued Operations” and unless otherwise noted, the notes to the unaudited condensed consolidated financial statements reflect the Company’s continuing operations. These financial statements contain certain reclassifications of prior period amounts to be consistent with the current period presentation with no effect on net income or loss.

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 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 (“LAE”), estimates of premiums written, premiums earned, acquisition costs, fair value of investments 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.

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

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 should be read in conjunction with the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011 (the "2011 Annual Report"), filed with the Securities and Exchange Commission ("SEC") on March 13, 2012.

### 3. NEW ACCOUNTING PRONOUNCEMENTS

The Company describes its significant accounting policies in the 2011 Annual Report. There has been no change to our significant accounting policies since December 31, 2011.

### 4. ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

On October 24, 2011, the Company announced its plan to undertake a number of strategic initiatives designed to realign the Company's strategy and core capabilities. As a result of this realignment, the Company commenced a formal process to divest its ownership positions in its former Lloyd's and Island Heritage reportable segments. The sale of the Company's ownership position in Island Heritage was completed on April 5, 2012, for total proceeds of \$70.1 million, of which the Company received \$42.1 million for its approximate 60% interest. The divestiture has been recorded in the second quarter results and resulted in a gain on disposal of \$4.5 million. On April 3, 2012, the Company announced that it had entered into a definitive agreement to divest its former Lloyd's reportable segment. The UK Financial Services Authority has approved the change in control and the Company now expects other regulatory approvals to be obtained, and the transaction completed, by August 31, 2012, for total proceeds of approximately \$49.7 million. Our letter of credit for Funds at Lloyd's in the amount of approximately \$158.7 million will also be released on the same day. The divestiture will be recorded in the third quarter results and the Company anticipates a small gain on disposal, net of any deal-related expenses.

The Company has classified the assets and liabilities associated with its former Lloyd's reportable segment as held for sale and the assets and liabilities have been recorded at the lower of the carrying value or fair value less costs to sell. The financial results for these operations have been presented as discontinued operations in the Company's consolidated statements of operations for all periods presented. The financial results of the Company's former Island Heritage reportable segment have been presented as discontinued operations for all periods presented up to and including March 31, 2012.

Details of the assets and liabilities of discontinued operations held for sale as at June 30, 2012 and December 31, 2011 are as follows:





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

	As at June 30, 2012	As at December 31, 2011
Assets of discontinued operations held for sale		
Fixed maturity investments, at fair value	\$ 71,573	\$ 94,422
Short term investments, at fair value	-	4,444
Total investments	71,573	98,866
Cash and cash equivalents	47,884	91,794
Restricted cash	91,230	30,307
Premium balances receivable	103,503	99,075
Unearned premiums ceded	24,165	27,042
Reinsurance recoverable	25,023	17,934
Deferred acquisition costs	23,928	26,949
Goodwill and intangible assets	33,619	44,161
Other assets	10,204	15,836
Total assets of discontinued operations held for sale	\$ 431,129	\$ 451,964
Liabilities of discontinued operations held for sale		
Loss and loss adjustment expense reserves	\$ 240,688	\$ 233,290
Unearned premiums	126,997	142,713
Insurance and reinsurance balances payable	17,892	27,400
Amounts due to affiliates	-	46,682
Other liabilities	8,237	22,872
Total liabilities of discontinued operations held for sale	\$ 393,814	\$ 472,957
Net assets (liabilities) of discontinued operations held for sale	\$ 37,315	\$ (20,993)

The increase in net assets of discontinued operations during the six months ended June 30, 2012, is primarily the result of amounts due to affiliates being capitalized and letters of credit being extinguished by placing funds directly with Lloyd's of London.

The Company has reclassified the results of operations of the discontinued operations to income (loss) from discontinued operations in its consolidated statements of operations. Details of the income from discontinued operations for the three and six months ended June 30, 2012 and 2011 are as follows:

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
Revenues				
Gross premiums written	\$ 65,419	\$ 82,364	\$ 152,344	\$ 151,841
Premiums ceded	(6,683)	(37,946)	(34,549)	(59,187)
Net premiums written	58,736	44,418	117,795	92,654
Net premiums earned	\$ 38,737	\$ 52,657	\$ 97,900	\$ 102,094

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Other reinsurance income	528	1,442	650	5,385
Loss and loss adjustment expenses	(26,099)	(18,705)	(50,529)	(65,455)
Acquisition costs	(10,103)	(13,444)	(23,970)	(27,129)
General and administrative expenses	(6,078)	(9,441)	(15,450)	(18,459)
Underwriting income (loss)	(3,015)	12,509	8,601	(3,564)
Gain on disposal of discontinued operations	4,522	-	4,522	-
Other income (expenses)	(139)	745	583	209
(Provision) recovery for income tax	(220)	706	(86)	5,092
Income from discontinued operations	\$ 1,148	\$ 13,960	\$ 13,620	\$ 1,737

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

## Assets held for sale

During the year ended December 31, 2011, the Company decided to dispose of its one remaining aircraft as well as corporate apartments, which will no longer be required due to the divestiture plans discussed above. The sale of the corporate apartments was completed on April 13, 2012, and has been recorded in second quarter results for total proceeds of approximately \$1.3 million, which resulted in a gain on disposal of \$0.1 million. The aircraft asset is reflected in assets held for sale including discontinued operations on the consolidated balance sheet as at June 30, 2012, at a carrying value of \$8.5 million. The Company does not anticipate a significant gain or loss on disposal of the aircraft.

## 5. INVESTMENTS

## Fixed maturity, short term, equity and other investments

The amortized cost or cost, gross unrealized gains and losses, and fair values as at June 30, 2012 and December 31, 2011 are as follows:

	Amortized cost or cost	As at June 30, 2012		Fair value
		Gross unrealized gains	Gross unrealized losses	
Fixed maturity investments				
Other foreign governments	\$ 20,359	\$ 997	\$ -	\$ 21,356
Mortgage-backed securities	137,655	405	(6,416)	131,644
Asset-backed securities	184,477	92	(3,895)	180,674
	342,491	1,494	(10,311)	333,674
Short term investments				
U.S. government and agency securities	690,486	6	-	690,492
Corporates	6,351	-	(5)	6,346
	696,837	6	(5)	696,838
Equity investments	236	-	(175)	61
	236	-	(175)	61
Other investments				
Investment funds	69,155	4,451	(5,371)	68,235
Catastrophe bonds	71,880	320	(438)	71,762
	141,035	4,771	(5,809)	139,997
Totals	\$ 1,180,599	\$ 6,271	\$ (16,300)	\$ 1,170,570



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	As at December 31, 2011			Fair value
	Amortized cost or cost	Gross unrealized gains	Gross unrealized losses	
<b>Fixed maturity investments</b>				
U.S. government and agency securities	\$ 320,666	\$ 3,352	\$ (237)	\$ 323,781
Other foreign governments	102,116	7,874	(475)	109,515
Corporates	471,025	11,362	(10,041)	472,346
Mortgage-backed securities	182,610	384	(7,904)	175,090
Asset-backed securities	59,338	7	(1,642)	57,703
	1,135,755	22,979	(20,299)	1,138,435
<b>Short term investments</b>				
U.S. government and agency securities	3,023	1	(1)	3,023
Other foreign governments	496	-	-	496
Corporates	7,101	-	(4)	7,097
	10,620	1	(5)	10,616
Equity investments	245	-	(163)	82
	245	-	(163)	82
<b>Other investments</b>				
Investment funds	67,661	-	(8,383)	59,278
Catastrophe bonds	63,000	1,016	-	64,016
	130,661	1,016	(8,383)	123,294
<b>Totals</b>	<b>\$ 1,277,281</b>	<b>\$ 23,996</b>	<b>\$ (28,850)</b>	<b>\$ 1,272,427</b>

Other investments do not include an investment accounted for under the equity method in which the Company has significant influence and accordingly, is not accounted for at fair value under the FASB ASC guidance for financial instruments. This investment was recorded at \$2.4 million and \$2.2 million at June 30, 2012 and December 31, 2011, respectively.

The country composition of the other foreign government classifications including the amortized cost or cost, gross unrealized gains and losses, and fair values as at June 30, 2012 and December 31, 2011 are as follows:

	As at June 30, 2012			Fair value
	Amortized cost or cost	Gross unrealized gains	Gross unrealized losses	
Other foreign governments				

Sovereign Debt

Other (excluding Eurozone)	\$	20,359	\$	997	\$	-	\$	21,356
Totals	\$	20,359	\$	997	\$	-	\$	21,356

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	Amortized cost or cost	As at December 31, 2011		Fair value
		Gross unrealized gains	Gross unrealized losses	
Other foreign governments				
Sovereign debt				
Other (excluding Eurozone)	\$ 49,667	\$ 4,527	\$ (46)	\$ 54,148
	49,667	4,527	(46)	54,148
Financial institutions				
Eurozone				
Portugal, Ireland, Italy, Greece & Spain	-	-	-	-
Other	7,740	149	(403)	7,486
Total	7,740	149	(403)	7,486
Other (excluding Eurozone)	45,205	3,198	(26)	48,377
	52,945	3,347	(429)	55,863
Totals	\$ 102,612	\$ 7,874	\$ (475)	\$ 110,011

The following table presents the contractual maturity dates of fixed maturity and short term investments and their respective amortized cost and fair values as at June 30, 2012 and December 31, 2011.

	As at June 30, 2012		As at December 31, 2011	
	Amortized cost	Fair value	Amortized cost	Fair value
Due within one year	\$ 696,837	\$ 696,838	\$ 29,294	\$ 29,663
Due after 1 through 5 years	4,100	4,269	746,610	754,709
Due after 5 through 10 years	8,517	9,062	106,287	107,461
Due after 10 years	7,742	8,025	22,236	24,425
Mortgage and asset-backed securities	322,132	312,318	241,948	232,793
Total	\$ 1,039,328	\$ 1,030,512	\$ 1,146,375	\$ 1,149,051

Actual maturities may differ from contractual maturities because certain borrowers have the right to prepay certain obligations with or without prepayment penalties.

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The following table presents a breakdown of the credit quality of the Company's fixed maturity and short term investments as at June 30, 2012 and December 31, 2011:

Rating Category	As at June 30, 2012		As at December 31, 2011	
	Fair value	Percentage of total	Fair value	Percentage of total
AAA	\$ 1,002,469	97.3 %	\$ 695,931	60.6 %
AA	2,678	0.3 %	92,299	8.0 %
A	24,998	2.4 %	231,143	20.1 %
BBB	367	0.0 %	129,678	11.3 %
Total	\$ 1,030,512	100.0 %	\$ 1,149,051	100.0 %

The Company has included credit rating information with respect to the Company's investment portfolio to supplement the reader's understanding of its composition and the consistency of the Company's investment portfolio with the Company's investment philosophy.



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## Fair value disclosure

The valuation technique used to determine the fair value of the financial instruments is the market approach which uses prices and other relevant information generated by market transactions involving identical or comparable assets.

In accordance with the Fair Value Measurements and Disclosures Topic of the FASB ASC, the Company has classified its investments in U.S. government treasury securities and listed equity securities as Level 1 in the fair value hierarchy. The fair value of these securities is the quoted market price of these securities, as provided either by independent pricing services or exchange market prices.

Investments in U.S. government agency securities, corporate bonds, mortgage-backed securities, foreign government bonds and asset-backed securities are classified as Level 2 in the fair value hierarchy. The fair value of these securities is derived from broker quotes based on inputs that are observable for the asset, either directly or indirectly, such as yield curves and transactional history. Catastrophe bonds are classified as Level 2 in the fair value hierarchy as determined by reference to independent pricing services. 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.

Investments in investment funds are classified as Level 3 in the fair value hierarchy. The fair value of the private equity funds is determined by the investment fund managers using the net asset value provided by the administrator or manager of the funds and adjusted based on analysis and discussions with the fund managers. The fair value of the mortgage-backed and distressed debt investment funds is determined by the net asset valuation provided by the independent administrator of the fund. These valuations are then adjusted for cash flows since the most recent valuation, which is a methodology generally employed in the investment industry.

As at June 30, 2012 and December 31, 2011, the Company's investments are allocated among fair value levels as follows:

	Fair Value Measurement at June 30, 2012 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				
Other foreign governments	\$ 21,356	\$ -	\$ 21,356	\$ -
Residential mortgage-backed securities	131,644	-	131,644	-
Asset-backed securities	180,674	-	180,674	-
	333,674	-	333,674	-
Short term investments				
U.S. government and agency securities	690,492	690,492	-	-

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Corporates	6,346	-	6,346	-
	696,838	690,492	6,346	-
<b>Equity investments</b>				
Financial services	61	61	-	-
	61	61	-	-
<b>Other investments</b>				
Investment funds	68,235	-	-	68,235
Catastrophe bonds	71,762	-	71,762	-
	139,997	-	71,762	68,235
Totals	\$ 1,170,570	\$ 690,553	\$ 411,782	\$ 68,235

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	Fair Value Measurement at December 31, 2011 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				
U.S. government and agency securities	\$ 323,781	\$ 264,096	\$ 59,685	\$ -
Other foreign government	109,515	-	109,515	-
Corporates	472,346	-	472,346	-
Residential mortgage-backed securities	175,090	-	175,090	-
Asset-backed securities	57,703	-	57,703	-
	1,138,435	264,096	874,339	-
Short term investments				
U.S. government and agency securities	3,023	-	3,023	-
Other foreign government	496	-	496	-
Corporates	7,097	-	7,097	-
	10,616	-	10,616	-
Equity investments				
Financial services	82	82	-	-
	82	82	-	-
Other investments				
Investment funds	59,278	-	-	59,278
Catastrophe bonds	64,016	-	64,016	-
	123,294	-	64,016	59,278
<b>Totals</b>	<b>\$ 1,272,427</b>	<b>\$ 264,178</b>	<b>\$ 948,971</b>	<b>\$ 59,278</b>

Other investments do not include an investment accounted for under the equity method in which the Company has significant influence and accordingly, is not accounted for at fair value under the FASB ASC guidance for financial instruments. This investment was recorded at \$2.4 million and \$2.2 million at June 30, 2012 and December 31, 2011, respectively.

The reconciliation of the fair value for the Level 3 investments for the period ended June 30, 2012, including purchases and sales and change in realized and unrealized gains (losses) in earnings, is set out below:

For the six months  
ended  
June 30, 2012

Fair value, December 31, 2011	\$	59,278
Total realized losses included in earnings		-
Total unrealized gains included in earnings		5,926
Purchases		1,420
Sales		(117)
Fair value, March 31, 2012	\$	66,507
Total realized losses included in earnings		-
Total unrealized gains included in earnings		1,537
Purchases		355
Sales		(164)
Fair value, June 30, 2012	\$	68,235

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For the Level 3 items still held as of June 30, 2012, the total change in fair value for the three and six months ended June 30, 2012 was \$1.6 million and \$7.5 million, respectively. Transfers between levels, if necessary, are done as of the actual date of the event or change in circumstance that caused the transfer. There were no transfers between levels during the three and six months ended June 30, 2012.

## Other investments

The Catastrophe bonds pay a variable and fixed interest coupon and generate investment return, and their performance is contingent upon climatological and geological events.

The Company's investment funds consist of investments in private equity, distressed debt and mortgage-backed investment funds. As at June 30, 2012 and December 31, 2011, the Company had total outstanding investment commitments of \$8.9 million and \$10.7 million, respectively. Redemptions from these investments occur at the discretion of the general partner, board of directors or, in other cases, subject to a majority vote by the investors. The Company is not able to redeem a significant portion of these investments prior to 2017.

The following table presents the fair value of the Company's investment funds as at June 30, 2012 and December 31, 2011:

	As at	
	June 30, 2012	December 31, 2011
Distressed debt funds	\$ 18,052	\$ 14,876
Mortgage-backed investment funds	38,441	33,789
Private equity funds	11,742	10,613
Total	\$ 68,235	\$ 59,278

## Pledged assets

The Company holds cash and cash equivalents and fixed maturity investments that were deposited or pledged in favor of ceding companies and other counterparties or government authorities to comply with reinsurance contract provisions, Lloyd's of London requirements and insurance laws.

The total amount of such deposited or pledged cash and cash equivalents and fixed maturity investments as at June 30, 2012 and December 31, 2011 are as follows:

	As at	
	June 30, 2012	December 31, 2011
Cash and cash equivalents	\$ 17,823	\$ 17,538
Fixed maturity investments	603,103	659,243
Total	\$ 620,926	\$ 676,781

## 6. DERIVATIVES

The Company accounts for its derivative instruments using the Derivatives and Hedging Topic of the FASB ASC, which requires an entity to recognize all derivative instruments as either assets or liabilities on 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 the hedge designation and, if designated as a hedging instrument, whether the hedge is 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.

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The Company enters into derivative instruments such as interest rate futures contracts, foreign currency forward contracts and currency swaps in order to manage portfolio duration and interest rate risk, borrowing costs and foreign currency exposure. The Company enters into index futures contracts to gain exposure to the underlying asset or index and enters into foreign currency forward contracts and foreign currency futures contracts to gain exposure to currency movements against the U.S. dollar. The Company also purchases “to be announced” mortgage-backed securities (“TBAs”) as part of its investing activities. The Company manages the exposure to these instruments in accordance with guidelines established by management and approved by the Company’s Board of Directors (the “Board”).

The Company has entered into certain foreign currency forward contracts for the purpose of hedging its net investments in foreign subsidiaries, and has designated these as hedging instruments. These foreign currency forward contracts are carried at fair value and the realized and unrealized gains and losses 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.

The details of the derivatives held by the Company as at June 30, 2012 and December 31, 2011 are as follows:

	As at June 30, 2012			
	Asset derivatives recorded in other assets Fair value	Liability derivatives recorded in other liabilities Fair value	Total derivatives Net notional exposure	Fair value
Derivatives designated as hedging instruments				
Foreign currency forward contracts(1)	\$ -	\$ 1,065	\$ 51,947	\$ (1,065)
	-	1,065		(1,065)
Derivatives not designated as hedging instruments				
Purpose - risk management				
Currency swaps	\$ -	\$ 1,481	\$ 16,446	\$ (1,481)
Foreign currency forward contracts	9,508	12,492	416,428	(2,984)
	9,508	13,973		(4,465)
Total derivatives	\$ 9,508	\$ 15,038		\$ (5,530)





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	As at December 31, 2011			
	Asset derivatives recorded in other assets	Liability derivatives recorded in other liabilities	Total derivatives	
	Fair value	Fair value	Net notional exposure	Fair value
Derivatives designated as hedging instruments				
Foreign currency forward contracts (1)	\$ -	\$ 498	\$ 51,564	\$ (498)
	-	498		(498)
Derivatives not designated as hedging instruments				
Purpose - risk management				
Currency swaps	\$ -	\$ 999	\$ 16,825	\$ (999)
Foreign currency forward contracts	15,196	7,685	648,556	7,511
Futures contracts	-	4,820	426,362	(4,820)
	15,196	13,504		1,692
Purpose - exposure				
Futures contracts	\$ -	\$ 206	\$ 7,685	\$ (206)
Foreign currency forward contracts	7	-	4,993	7
	7	206		(199)
	15,203	13,710		1,493
Total derivatives	\$ 15,203	\$ 14,208		\$ 995

## Designated

Derivatives designated as hedging instruments	Amount of Gain or (Loss) on Derivatives Recognized in				
	Comprehensive income (loss) (Effective portion)		Location	Net income (loss) (Ineffective portion)	
	For the three months ended June 30,			For the three months ended June 30,	
	2012	2011		2012	2011

			Net realized and unrealized losses - other		
Foreign currency forward contracts(1)	\$ 3,120	\$ (831)		\$ (56)	\$ (124)
	\$ 3,120	\$ (831)		\$ (56)	\$ (124)

Amount of Gain or (Loss) on Derivatives Recognized in  
Comprehensive income (loss) Net income (loss)  
(Effective portion) (Ineffective portion)

Derivatives designated as hedging instruments	For the six months ended June 30,		Location	For the six months ended June 30,	
	2012	2011		2012	2011
Foreign currency forward contracts(1)	\$ 961	\$ (2,040)	Net realized and unrealized losses - other	\$ (401)	\$ (349)
	\$ 961	\$ (2,040)		\$ (401)	\$ (349)

(1) Recognized as a foreign currency hedge under the Derivatives and Hedging Topic of the ASC.

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## Non-Designated

## Gain or (Loss) on Derivatives Recognized in Net Income

Derivatives not designated as hedging instruments	Location	For the three months ended June 30,	
		2012	2011
Futures contracts	Net realized and unrealized losses - investments	\$ (74)	\$ (16,554)
Currency swaps	Net realized and unrealized (losses) gains - other	(937)	467
Foreign currency forward contracts	Net realized and unrealized gains (losses) - investments	15,584	(17,542)
Foreign currency forward contracts	Net realized and unrealized (losses) gains - other	(3,997)	13,643
		\$ 10,576	\$ (19,986)

## Gain or (Loss) on Derivatives Recognized in Net Income

Derivatives not designated as hedging instruments	Location	For the six months ended June 30,	
		2012	2011
Futures contracts	Net realized and unrealized gains (losses) - investments	\$ 179	\$ (8,986)
Currency swaps	Net realized and unrealized (losses) gains - other	(509)	1,547
Foreign currency forward contracts	Net realized and unrealized gains (losses) - investments	3,026	(51,518)
Foreign currency forward contracts	Net realized and unrealized gains - other	2,303	11,857
Mortgage-backed securities TBA	Net realized and unrealized losses - investments	-	(2)
Other reinsurance derivatives	Net realized and unrealized gains - other	-	241
		\$ 4,999	\$ (46,861)

## Foreign currency forward contracts

The Company enters into foreign currency forward contracts for the purpose of hedging its net investment in foreign subsidiaries which are recorded as designated hedges. Foreign currency forward contracts are also entered into for the purpose of hedging the Company's foreign currency fixed maturity investments, select investment funds and the Company's net foreign currency operational assets and liabilities. Foreign currency forward contracts are also entered into for the purpose of gaining exposure to currency movements against the U.S. dollar.

## Futures contracts

The Company uses futures contracts to gain exposure to U.S. equity, global equity, emerging market equity and commodities. The Company uses interest rate futures contracts to manage the duration of the fixed maturity investments and foreign currency futures contracts to gain exposure to currency movements against the U.S. dollar.

#### Currency swaps

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

#### To be announced mortgage-backed securities

The Company also purchases 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 in accordance with the FASB ASC Topic for Derivatives and Hedging. 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

Derivative instruments are stated at fair value in accordance with the Fair Value Measurements and Disclosures Topic of the FASB ASC as determined by the quoted market price for futures contracts and based on observable market inputs for foreign currency forward contracts, currency swaps and TBAs. The Company fair values reinsurance derivative contracts, which are under one year in duration, by approximating the present value of cash flows as the carrying value equal to the unearned premium.

In accordance with the Fair Value Measurements and Disclosures Topic of the FASB ASC, the fair value of derivative instruments held as at June 30, 2012 and December 31, 2011 is allocated between levels as follows:

Description	Fair value measurements	Fair Value Measurement at June 30, 2012, using:		
		Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
Swaps	\$ (1,481)	\$ -	\$ (1,481)	\$ -
Foreign currency forward contracts	(4,049)	-	(4,049)	-
Total derivatives	\$ (5,530)	\$ -	\$ (5,530)	\$ -

For the Level 3 items still held as of June 30, 2012, the total change in fair value for the three and six months ended June 30, 2012, recorded in net realized and unrealized gains (losses) – other, was \$nil.

Description	Fair value measurements	Fair Value Measurement at December 31, 2011, using:		
		Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
Futures contracts	\$ (5,026)	\$ (5,026)	\$ -	\$ -
Swaps	(999)	-	(999)	-
Foreign currency forward contracts	7,020	-	7,020	-
Total derivatives	\$ 995	\$ (5,026)	\$ 6,021	\$ -

At June 30, 2012 and December 31, 2011, there were no Level 3 derivative instruments held. Transfers between levels, if necessary, are done as of the actual date of the event or change in circumstance that caused the transfer. There were no transfers between levels during the three and six months ended June 30, 2012.

## 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 and six months ended June 30, 2012, the Company incurred interest expense of \$2.5 million and \$5.0 million, respectively, on the Deferrable Interest Debentures compared to \$2.6 million and \$5.2 million, respectively, for the same periods in 2011. The Company had \$0.8 million of interest payable included in other liabilities at both June 30, 2012 and December 31, 2011.

The Company does not carry its long term debt at fair value on its consolidated balance sheets. At June 30, 2012, the Company estimated the fair value of its long term debt to be approximately \$212.7 million compared to \$192.7 million at December 31, 2011.

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Letter of credit facilities

On August 31, 2011, Flagstone Suisse and Flagstone Capital Management Luxembourg SICAF – FIS (“FCML”) entered into a \$200.0 million secured committed letter of credit facility with Barclays Bank Plc (the “Barclays Facility”). The Barclays Facility is for letters of credit with a maximum tenor of 15 months and is used to support the reinsurance obligations of the Company. As of June 30, 2012, \$46.0 million had been drawn under the Barclays Facility, and the drawn amount was secured by \$48.4 million of fixed maturity investments from the Company’s investment portfolio. The Barclays Facility replaced a \$200.0 million credit facility with Barclays Bank Plc which commenced on March 5, 2009.

On April 28, 2010, Flagstone Suisse and FCML entered into a secured \$450.0 million standby letter of credit facility with Citibank Europe Plc (the “Citi Facility”). The Citi Facility comprised a \$225.0 million facility for letters of credit with a maximum tenor of 15 months, to be used to support reinsurance obligations of the Company, and a \$225.0 million facility for letters of credit drawn in respect of Funds at Lloyd’s with a maximum tenor of 60 months. On December 21, 2010, the Citi Facility was amended to increase the amount available under the facility by \$100.0 million to \$550.0 million, with all the terms and conditions remaining unchanged. The Citi Facility now comprises a \$275.0 million facility for letters of credit with a maximum tenor of 15 months, to be used to support reinsurance obligations of the Company, and a \$275.0 million facility for letters of credit drawn in respect of Funds at Lloyd’s with a maximum tenor of 60 months. As at June 30, 2012, \$507.5 million had been drawn under the Citi Facility, and the drawn amount of the facility was secured by \$554.7 million of fixed maturity investments from the Company’s investment portfolio. The Citi Facility replaced a \$450.0 million credit facility with Citibank Europe Plc which commenced on January 22, 2009.

These facilities are used to provide security to reinsureds and for Funds at Lloyd’s, and they are fully collateralized by the Company, 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 the Compensation – Stock Compensation Topic of the FASB ASC which requires entities to measure the cost of services received from employees and directors 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 as compensation expense over the period during which an employee or director is required to provide service in exchange for the award. The Company’s share based compensation plans consist of Performance Share Units (“PSUs”) and Restricted Share Units (“RSUs”).

Performance Share Units

The Company’s 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, 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.

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A summary of the activity under the PSU Plan as at June 30, 2012, and changes during the three and six months ended June 30, 2012, is as follows:

	For the three months ended June 30, 2012			For the six months ended June 30, 2012		
	Number expected to vest	Weighted average grant date fair value	Weighted average remaining contractual term	Number expected to vest	Weighted average grant date fair value	Weighted average remaining contractual term
Outstanding at beginning of period	1,016,050	\$ 10.73	1.7	1,676,125	\$ 10.83	0.7
Granted	-	-		300,000	8.29	
Forfeited	(5,250)	11.65		(99,000)	11.54	
Performance factor changes	-	-		23,375	9.93	
Exercised	-	-		(889,700)	9.98	
Outstanding at end of period	1,010,800	10.73	1.4	1,010,800	10.73	1.4



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The Company reviews its assumptions in relation to the PSUs on a quarterly basis. The issuance of shares with respect to the PSUs is contingent upon the attainment of certain levels of average DROE over a three year period. Taking into account the results to date and the expected results for the remainder of the performance periods, the Company has established the most probable factor as the minimum for each series, with the exception of one series which has been established to have a probable factor of 60%. For the three and six months ended June 30, 2012, \$1.0 million and \$1.3 million, respectively, of compensation expense related to the PSU Plan has been recorded in general and administrative expenses compared to \$0.1 million and \$(4.1) million, respectively, for the same periods in 2011. As at June 30, 2012 and December 31, 2011, there was a total of \$4.8 million and \$4.8 million, respectively, of unrecognized compensation cost related to non-vested PSUs; that cost is expected to be recognized over periods of approximately 1.8 years and 1.6 years, respectively.

Since the inception of the PSU Plan, 2,363,026 PSUs have vested and 2,368,658 PSUs have been cancelled.

#### Restricted Share Units

The purpose of the Company's Restricted Share Unit Plan (the "RSU Plan") is to encourage certain 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 and RSUs granted to directors vest on the grant date.

A summary of the activity under the RSU Plan as at June 30, 2012, and changes during the three and six months ended June 30, 2012, is as follows:

	For the three months ended June 30, 2012			For the six months ended June 30, 2012		
	Number expected to vest	Weighted average grant date fair value	Weighted average remaining contractual term	Number expected to vest	Weighted average grant date fair value	Weighted average remaining contractual term
Outstanding at beginning of period	553,615	\$ 10.40	1.3	524,179	\$ 11.40	0.3
Granted	3,000	7.87		220,706	8.27	
Forfeited	(12,100)	9.78		(53,350)	10.56	
Exercised	-	-		(147,020)	10.68	
Outstanding at end of period	544,515	10.40	1.1	544,515	10.40	1.1

Unrecognized compensation cost related to non-vested RSUs was \$1.3 million and \$1.0 million at June 30, 2012 and December 31, 2011, respectively, and is expected to be recognized over a period of approximately 1.2 years and 1.0 year, respectively. Compensation expenses related to the RSU Plan of \$0.3 million and \$1.0 million, respectively,

were recorded in general and administrative expenses for the three and six months ended June 30, 2012 compared to \$0.3 million and \$1.6 million, respectively, for the same period in 2011.

Since the inception of the RSU Plan in July 2006, 707,262 RSUs granted to employees have vested and no RSUs granted to employees have been cancelled. During the three and six months ended June 30, 2012, nil and 59,856 RSUs, respectively, were granted to the directors, compared to nil and 63,964 RSUs, respectively, granted to directors during the same period in 2011. During both the three and six months ended June 30, 2012 and 2011, no RSUs 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 both PSUs and RSUs outstanding as at June 30, 2012 was \$8.1 million and \$4.4 million, respectively.

#### 9. EARNINGS (LOSS) PER COMMON SHARE

The computation of basic and diluted earnings (loss) per common share for the three and six months ended June 30, 2012 and 2011 is as follows:

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	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
<b>Basic earnings per common share</b>				
Net income (loss) attributable to Flagstone	\$ 13,490	\$ (20,210)	\$ 52,675	\$ (181,430)
Weighted average common shares outstanding	71,058,922	70,056,431	70,740,893	69,544,000
Weighted average vested restricted share units	293,565	324,421	274,819	325,195
Weighted average common shares outstanding—Basic	71,352,487	70,380,852	71,015,712	69,869,195
Basic earnings (loss) per common share	\$ 0.19	\$ (0.29)	\$ 0.74	\$ (2.60)
<b>Diluted earnings per common share</b>				
Net income (loss) attributable to Flagstone	\$ 13,490	\$ (20,210)	\$ 52,675	\$ (181,430)
Weighted average common shares outstanding	71,058,922	70,056,431	70,740,893	69,544,000
Weighted average vested restricted share units outstanding	293,565	324,421	274,819	325,195
	71,352,487	70,380,852	71,015,712	69,869,195
<b>Share equivalents:</b>				
Weighted average unvested restricted share units	76,309	-	134,213	-
Weighted average unvested performance share units	335,108	-	422,204	-
Weighted average common shares outstanding—Diluted	71,763,904	70,380,852	71,572,129	69,869,195
Diluted earnings (loss) per common share	\$ 0.19	\$ (0.29)	\$ 0.74	\$ (2.60)

Dilutive share equivalents have been excluded in the weighted average common shares used for the calculation of earnings per share in periods of net loss because the effect of such securities would be anti-dilutive. The number of anti-dilutive share equivalents that were excluded in the computation of diluted earnings per share for the three and six months ended June 30, 2011, was 749,424 and 956,246, respectively. Because the number of shares above a minimum threshold are contingently issuable under the PSU Plan depends on the average DROE over a two or three year period, those contingently issuable 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. Only the minimum number of PSUs that will vest under each grant are included in the calculation of diluted earnings in a period of net income. As at June 30, 2012 and 2011, there were 1,010,800 and 1,762,442 PSUs expected to vest,

respectively. The maximum number of common shares that could be issued under the PSU Plan at June 30, 2012 and 2011 was 2,318,200 and 4,889,492, respectively. There was a warrant outstanding which would result in the issuance of 630,194 common shares at both June 30, 2012 and 2011, that were excluded from the computation of diluted earnings per common share because the effect would be anti-dilutive.

## 10. SHAREHOLDERS' EQUITY

### Common shares

At June 30, 2012, the total authorized common voting shares of the Company were 300,000,000, with a par value of \$0.01 per common share (December 31, 2011 – 300,000,000).

The following table is a summary of the common shares issued and outstanding for the periods ending June 30, 2012 and December 31, 2011:

	For the periods ended	
	June 30, 2012	December 31, 2011
Common voting shares:		
Balance at beginning of period	70,167,142	68,585,588
Conversion of performance share units (1)	782,179	1,359,378
Conversion of restricted share units (1)	109,601	222,176
Balance at end of period	71,058,922	70,167,142

(1) Conversion of performance share units and restricted share units are net of shares withheld for the payment of tax on the employee's behalf.

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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. Such proceedings often involve reinsurance contract disputes which are typical for the insurance and reinsurance industry. As at June 30, 2012, the Company was not a party to any material litigation or arbitration proceedings.

12. SUBSEQUENT EVENTS

The Company has evaluated subsequent events through to the date the financial statements were available to be issued and has determined that there were no subsequent events that require disclosure, except in connection with the divestiture processes relating to the former Lloyd's reportable segment. Refer to Note 4 "Assets Held for Sale and Discontinued Operations" for more information.

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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 June 30, 2012 and December 31, 2011, and our results of operations for the three and six months ended June 30, 2012 and 2011, including, as specified, our discontinued operations. The historical results presented in this Quarterly Report are not necessarily indicative of the results to be expected for any future period and results for any interim period may not necessarily be indicative of the results expected for a full year. 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 Quarterly Report on Form 10-Q (this "Quarterly Report") 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 our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 (our "2011 Annual Report"), filed with the SEC on March 13, 2012. 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 the information described under "Recent Developments", the risks described in this Quarterly Report and in Item 1A, "Risk Factors" contained in the 2011 Annual Report 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 to the "Company", "Flagstone", "we", "us", and "our" refer to Flagstone Reinsurance Holdings, S.A. and/or its subsidiaries, including Flagstone Réassurance Suisse SA, its wholly-owned Switzerland reinsurance company, Flagstone Alliance Insurance & Reinsurance PLC, its wholly-owned Cyprus insurance and reinsurance company, Flagstone Reinsurance Africa Limited, its wholly-owned South African reinsurance company, Mont Fort Re Ltd., its wholly-owned Bermuda reinsurance company, and any other direct or indirect wholly-owned subsidiary, but not including its United Kingdom Lloyd's managing agency Flagstone Syndicate Management Limited, or Island Heritage Holdings Ltd., each of which are discontinued operations, unless the context suggests otherwise. On October 24, 2011, we announced a strategic decision to divest our ownership positions in our former Lloyd's and Island Heritage reportable segments. On April 5, 2012, the Company completed the sale of the business comprising its former Island Heritage reportable segment. On April 3, 2012, the Company announced that it had entered into definitive agreements to divest the business comprising its former Lloyd's reportable segment. The Company has classified the assets and liabilities associated with its former Lloyd's and Island Heritage reportable segments as held for sale and the assets and liabilities have been recorded at the lower of the carrying value or fair value less costs to sell. The financial results for the Lloyd's discontinued operations have been presented as discontinued operations in the Company's consolidated statements of operations for all periods presented and the financial results for the Island Heritage discontinued operations have been presented as discontinued operations in the Company's consolidated statements of operations for all periods presented up to and including March 31, 2012. Unless otherwise noted, all discussions and amounts presented in this Quarterly Report relate to our business without giving effect to our discontinued operations. References to "Flagstone Suisse" refer to Flagstone Réassurance Suisse SA, its wholly-owned subsidiaries and its Bermuda branch. References to "FSML" refer to Flagstone Syndicate Management Limited, its wholly-owned subsidiaries and Syndicate 1861. References to "Island Heritage" refer to Island Heritage Holdings Ltd. and its subsidiaries. References to "Flagstone Africa" refer to Flagstone Reinsurance Africa Limited. References to "Mont Fort" refer to Mont Fort Re Ltd. References in this Quarterly Report to "dollars" or "\$" are to the lawful currency of the United States of America (the "U.S."), 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, percentages or unless otherwise stated. References in this Quarterly Report to (i) "foreign currency" are to currencies other than U.S. dollars and (ii) "foreign exchange" transactions or "foreign investments" are to transactions or investments, respectively, involving currencies other than U.S. dollars, in each case unless the context otherwise requires. References in this Quarterly Report to "foreign subsidiaries" are to subsidiaries of Flagstone that are not domiciled in the U.S. or whose

primary transactions are in foreign currency.

#### Executive Overview

We are pleased with our second quarter results as we continue to benefit from the strategic shift in our business model as we become a more focused and efficient underwriter. Evidence of the effectiveness of this strategy and its benefits could be seen this quarter with reduced frequency and attritional losses, coupled with our ongoing expense saving initiatives, which drove positive underwriting performance despite significant tornado, wind, and wildfire industry losses in the United States during the quarter. Our improved performance in the second quarter also reflects the benefits of attractive rates in our core business, which partially offset the reduction in income as we continue to reposition our portfolio.

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We are, in all material respects, nearing the completion of the business realignment we announced in October 2011. As previously announced on April 2, 2012, and April 3, 2012, the Company entered into definitive agreements to divest its former Island Heritage and Lloyd's reportable segments, respectively. The Island Heritage transaction was completed on April 5, 2012, and has been recorded in the second quarter results, including a gain on disposal of \$4.5 million. The Lloyd's segment transaction is expected to be completed in the third quarter of 2012. Upon closing, we anticipate recording a small gain on this divestiture, net of any deal-related expenses. These divestitures are part of a strategic business realignment to address changing business conditions, refocus the Company's underwriting strategy on its property catastrophe reinsurance business and reduce its focus on operating segments that absorb capital and produce lower returns. Except as explicitly described as held for sale or as discontinued operations, and unless otherwise noted, all discussions and amounts presented herein relate to our continuing operations. See Note 4, "Assets Held for Sale and Discontinued Operations" in our unaudited condensed consolidated financial statements (Item 1 above) for additional information related to discontinued operations. All prior years presented have been reclassified to conform to this new presentation.

We are a global reinsurance company. Our management views the operations and management of our continuing operations as one reportable segment and does not differentiate our lines of business into separate reportable segments. Our continuing operations provide reinsurance primarily through our property and property catastrophe business as well as short-tail specialty and casualty reinsurance lines of business. We diversify our risks across business lines by risk zones, each of which combines a geographic zone with one or more types of peril (for example, Texas Windstorm, Florida Hurricane or California Earthquake). The majority of our reinsurance contracts contain loss limitation provisions such as fixed monetary limits to our exposure and per event caps. We specialize in underwriting where we believe sufficient data exists to analyze effectively the risk/return profile, and where we are subject to legal systems we believe are reasonably fair and reliable. Previously, the underwriting results associated with our discontinued operations were included in our former Lloyd's and Island Heritage reportable segments.

Our financial statements are prepared in accordance with accounting principles generally accepted in the U.S ("U.S. GAAP") and our fiscal year ends on December 31. Because a substantial portion of the reinsurance we write in our discontinued and continuing operations 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 coverages we offer to clients affected by these events. This has resulted and may continue to result in volatility in our results of operations, cash flows 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 available capital and retrocessional support and market and other conditions.

We measure our financial success through long term growth in diluted book value per share plus accumulated distributions measured over intervals of three years. We believe this is the most appropriate measure of our performance, a measure that focuses on the return provided to our common shareholders. Diluted book value per share is obtained by dividing Flagstone shareholders' equity by the number of common shares and common share equivalents outstanding including all potentially dilutive securities such as a warrant, Performance Share Units ("PSUs") and Restricted Share Units ("RSUs").

Our continuing operations derive revenues primarily from net premiums earned on the reinsurance policies we write, net of any retrocessional or reinsurance coverage purchased, 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 12 or 24 months.



Income from our investment portfolio primarily comprises interest on fixed maturity, short term investments and cash and cash equivalents and net realized and unrealized gains (losses) on our investment portfolio including our derivative positions, net of investment expenses.

Our expenses consist primarily of the following: loss and loss adjustment expenses (“LAE”) incurred on the policies of reinsurance 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 Performance Share Unit Plan (“PSU Plan”) and Restricted Share Unit Plan (“RSU Plan”), and other general operating expenses; interest expense related to our debt obligations; and noncontrolling interest, which represents the interest of external parties with respect to the net income of Mont Fort (on March 25, 2011 there were no longer third party investors in Mont Fort) and our Island Heritage discontinued operations. 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. The Company is a Luxembourg tax resident entity due to its change of jurisdiction of incorporation from Bermuda to Luxembourg effective May 17, 2010 (the “Redomestication”); therefore, it is subject to Luxembourg corporate income tax, municipal business tax, withholding tax, and net wealth tax. The Company minimizes the income tax impact on the Company through effective tax planning.

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## Recent Developments

On April 3, 2012, the Company announced that it had entered into a definitive agreement with a wholly-owned subsidiary of ANV Holdings BV (“ANV”), under which ANV, with capital support from Ontario Teachers’ Pension Plan Board, will acquire the Company’s Lloyd’s operations. The UK Financial Services Authority has approved the change in control and the Company now expects other regulatory approvals to be obtained, and the transaction completed, by August 31, 2012, for total proceeds of approximately \$49.7 million. Our letter of credit for Funds at Lloyd’s in the amount of approximately \$158.7 million will also be released on the same day. The divestiture will be recorded in the third quarter results and the Company anticipates a small gain on disposal, net of any deal-related expenses.

You should review all the information in this Quarterly Report in conjunction with the information under this “Recent Developments.”

## Critical Accounting Policies

Our critical accounting policies are discussed in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Item 7 of the 2011 Annual Report. Our critical accounting policies at June 30, 2012 have not changed compared to December 31, 2011.

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 our management to make assumptions and best estimates to determine the reported values. If events or other factors, including those described herein and in Item 1A, “Risk Factors,” of the 2011 Annual Report, 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.

## Results of Operations - For the Three and Six Months Ended June 30, 2012 and 2011

Our reporting currency is the U.S. dollar. Our subsidiaries have one of the following functional currencies: U.S. dollar, Swiss franc, Euro, British pound sterling, Canadian dollar, Indian rupee, and South African rand. As a significant portion of our 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 “Significant Accounting Policies” to the consolidated financial statements in Item 8, “Financial Statements and Supplementary Data”, in the 2011 Annual Report for a discussion on translation of foreign currencies.

	For the three months ended		For the six months ended	
U.S. dollar strengthened (weakened) against:	June 30, 2012		June 30, 2012	
Canadian dollar	2.0	%	(0.1)	%
Swiss franc	4.9	%	1.0	%
Euro	5.1	%	2.2	%
British pound sterling	2.1	%	(0.8)	%
Indian rupee	8.8	%	4.9	%
South African rand	6.2	%	1.3	%



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## Summary Overview

The following table sets forth selected key financial information for the three months ending June 30, 2012 and 2011:

	For the three months ended June 30,			
	2012	2011	\$ Change	% Change
Underwriting income (loss)	\$ 6,990	\$ (22,496)	\$ 29,486	131.1 %
Net investment income	\$ 3,866	\$ 12,300	\$ (8,434)	(68.6)%
Net realized and unrealized gains (losses) - investments	\$ 5,365	\$ (7,905)	\$ 13,270	167.9 %
Net realized and unrealized (losses) gains - other	\$ (4,990)	\$ 13,986	\$ (18,976)	(135.7)%
Income (loss) from continuing operations	\$ 12,342	\$ (32,973)	\$ 45,315	137.4 %
Income (loss) from continuing operations per common share - Basic	\$ 0.17	\$ (0.49)	\$ 0.67	
Income (loss) from continuing operations per common share - Diluted(1)	\$ 0.17	\$ (0.49)	\$ 0.66	
Loss ratio	54.1 %	81.3 %		
Expense ratio	40.0 %	38.2 %		
Combined ratio	94.1 %	119.5 %		

The following table sets forth selected key financial information for the six months ended June 30, 2012 and 2011:

	For the six months ended June 30,			
	2012	2011	\$ Change	% Change
Underwriting income (loss)	\$ 11,607	\$ (178,316)	\$ 189,923	106.5 %
Net investment income	\$ 8,933	\$ 21,498	\$ (12,565)	(58.4)%
Net realized and unrealized gains - investments	\$ 23,468	\$ 2,866	\$ 20,602	718.8 %
Net realized and unrealized gains - other	\$ 1,393	\$ 13,296	\$ (11,903)	89.5 %
Income (loss) from continuing operations	\$ 40,190	\$ (181,146)	\$ 221,336	122.2 %
Income (loss) from continuing operations per common share - Basic	\$ 0.55	\$ (2.62)	\$ 3.17	
Income (loss) from continuing operations per common share - Diluted(1)	\$ 0.55	\$ (2.62)	\$ 3.17	
Loss ratio	56.4 %	125.0 %		
Expense ratio	39.5 %	31.1 %		

Combined ratio	95.9 %	156.1 %
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The following table sets forth selected key non-GAAP financial measures as at June 30, 2012 and December 31, 2011:

	June 30,	As at December 31,	\$	% Change
	2012	2011	Change	
Basic book value per common share	\$ 11.73	\$ 11.21	\$ 0.52	4.6 %
Diluted book value per common share	\$ 11.52	\$ 10.90	\$ 0.62	5.7 %
Diluted book value per common share plus accumulated distributions	\$ 12.32	\$ 11.62	\$ 0.70	6.0 %

(1) Income (loss) from continuing operations per common share - Diluted for the three and six months ended June 30, 2012 and 2011 does not contain the effect of:

- a warrant conversion as this would be anti-dilutive for U.S. GAAP purposes
- the PSU conversion until the end of the performance period, when the number of shares issuable under the PSU Plan will be known. There were 1,010,800 and 1,762,442 PSU's expected to vest under the PSU plan as at June 30, 2012 and 2011, respectively. Only the minimum number of PSUs that will vest under each grant are included in the calculation of diluted earnings in a period of net income.

The increase in underwriting income in the six months ended June 30, 2012, is primarily due to the lack of significant catastrophe losses (net of reinsurance and reinstatements) in the period compared to the same period last year, which included Australian floods (\$27.2 million), cyclone Yasi (\$29.8 million), New Zealand earthquake of February 2011 (\$114.8 million) and the Japan earthquake and tsunami (\$93.9 million).

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The decrease in net investment income on the three months ended June 30, 2012, is principally due to lower invested assets and the change in asset allocation during the quarter. The decrease in net investment income on the six months ended June 30, 2012, is primarily due to lower investment assets, the change in asset allocation and to lower interest rates during the period.

The increase in the net realized and unrealized gains and losses – investments, for the six months ended June 30, 2012, is primarily associated with the foreign currency forward contracts and is related to the currency hedges on non-U.S. dollar bonds, offset by net realized and unrealized gains on the fixed maturity investments as a result of tightening credit spreads, change in asset allocation and higher foreign currency impact on the portfolio.

The decrease in the net realized and unrealized gains and losses – other, for the six months ended June 30, 2012, is primarily associated with currency swaps and foreign currency forward contracts and is due to currency fluctuations which are partially offset by net gains recorded through balance sheet currency revaluations and are attributable to operational hedges on reinsurance balances.

These items are discussed in more detail in the following sections.

Non-GAAP Reconciliation

In addition to the U.S. GAAP financial measures set forth in this Quarterly Report, we have presented “basic book value per common share” and “diluted book value per common share”, which are non-GAAP financial measures. Our management uses growth in diluted book value per common share as a prime measure of the value we are generating for our common shareholders, as we believe that growth in our diluted book value per common share ultimately translates into growth in our stock price.

Basic book value per common share is defined as total Flagstone shareholders’ equity divided by the number of common shares outstanding at the end of the period plus vested RSUs, giving no effect to dilutive securities. Diluted book value per common share is defined as total Flagstone shareholders’ equity divided by the number of common shares and common share equivalents outstanding at the end of the period including all potentially dilutive securities such as a warrant, PSUs and RSUs. When the effect of securities would be anti-dilutive, these securities are excluded from the calculation of diluted book value per common share. The warrant was anti-dilutive and was excluded from the calculation of diluted book value per common share as at June 30, 2012 and December 31, 2011.

While we believe that these non-GAAP financial measures provide useful supplemental information to investors, there are limitations associated with the use of these non-GAAP financial measures. Basic book value per common share does not reflect the number of common shares that may be issued upon vesting or exercise of dilutive securities. On the other hand, by giving effect to dilutive securities, diluted book value per common share takes into account common share equivalents and not just the number of common shares actually outstanding. These non-GAAP financial measures are not prepared in accordance with GAAP, are not based on any comprehensive set of accounting rules or principles, are not reported by all of our competitors and may not be directly comparable to similarly titled measures of our competitors due to potential differences in the exact method of calculation. In light of these limitations, we use these non-GAAP financial measures only as supplements to GAAP financial measures and provide a reconciliation of the non-GAAP financial measures to their most comparable GAAP financial measures.

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		As at	
		June 30, 2012	December 31, 2011
Flagstone shareholders' equity	\$	836,660	\$ 789,048
Potential net proceeds from assumed:			
Exercise of PSU (1)		-	-
Exercise of RSU (1)		-	-
Conversion of warrant (2)		-	-
Diluted Flagstone shareholders' equity	\$	836,660	\$ 789,048
Cumulative distributions paid per outstanding common share	\$	0.80	\$ 0.72
Common shares outstanding - end of period		71,058,922	70,167,142
Vested RSUs		293,565	233,709
Total common shares outstanding - end of period		71,352,487	70,400,851
Potential shares to be issued:			
PSUs expected to vest		1,010,800	1,676,125
RSUs outstanding		250,950	290,470
Conversion of warrant (2)		-	-
Common shares outstanding - diluted		72,614,237	72,367,446
Basic book value per common share	\$	11.73	\$ 11.21
Diluted book value per common share	\$	11.52	\$ 10.90
Basic book value per common share plus accumulated distributions	\$	12.53	\$ 11.93
Diluted book value per common share plus accumulated distributions	\$	12.32	\$ 11.62
Distributions per common share paid during the period	\$	0.08	\$ 0.16

(1)No proceeds due when exercised

(2)Below strike price - not dilutive

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### Outlook and Trends

#### Market Outlook

At the important June 1, 2012 renewal period, North American rates were approximately flat to up 5% from rates a year ago. Rates were flat to down slightly in loss-free regions and ranging from flat to up 5% in loss-affected regions. Looking forward toward the next major North American renewal period at January 1, 2013, we would expect a similar range of rate levels barring any significant potential loss activity occurring during this hurricane season. Prior to renewal, many clients came out with their submissions early and therefore business transacted in an orderly fashion prior to June 1st. On average, clients sought slightly more capacity this year and moved retentions upwards in addition to an increase in demand from Citizens Property Insurance Corporation of Florida and the increased expected loss effects of Risk Management Solutions, Inc.'s new hurricane risk model ("RMS V11"). However, an increase in reinsurer capacity was allocated for this period, which meant that programs reached subscription and were slightly oversubscribed to meet this demand. On a regional basis, Florida, Southeast and Gulf of Mexico rates were strongest and overall, rate levels continue to be adequate with pricing mostly meeting return hurdles.

The second quarter is not overly meaningful to the International markets with the exception of April 1, 2012 Japan renewals where we saw strong pricing increases in these treaties. Overall price increases averaged over 20%. Comparing 2012 prices with pre-Tohoku pricing, loss affected Japanese earthquake programs paid 80-140% increases. Non-loss affected programs saw 40-75% increases and Japanese wind programs were up 15-25%. Outside of Japan, Latin America also renews during this period and rates in the region were flat to modestly up as larger players competed for market share. In summary, outside of Japan, capacity was generally abundant, and looking forward to the next major International renewal period at January 1, 2013, we expect the level of International loss activity to dictate the direction of rates.

Regarding the specialty lines, rates in the marine business, aviation, and aerospace and satellite have been flat since the January 1, 2012 renewal last quarter and as these lines renew throughout the remainder of the year we expect a similar pattern to continue. Rates have generally failed to increase materially and the modest profitability has been primarily due to a lack of loss activity.

This information should be read in conjunction with the other information in the 2011 Annual Report, including "Risk Factors— Risks Related to our Business".

#### Underwriting Results

Our management views our operations and management of our continuing operations as one reportable segment and does not differentiate its lines of business into separate reportable segments. We provide reinsurance through our property and property catastrophe business as well as high-margin short-tail specialty and casualty reinsurance lines of business. We regularly review our financial results and assess our performance on the basis of our single reportable segment in accordance with the Segment Reporting Topic of the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC").

Those lines of business are more fully described as follows:

- (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 property 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. Generally, our 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. Generally, our short-tail specialty and casualty reinsurance is written with loss limitation provisions.

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## Gross Premiums Written

Details of the consolidated gross premiums written by line of business and geographic area of risk insured for our continuing operations are provided below:

Line of business	2012		2011	
	Gross premiums written	Percentage of total	Gross premiums written	Percentage of total
Property catastrophe	\$ 126,755	74.1 %	\$ 170,394	64.5 %
Property	28,781	16.8 %	53,224	20.2 %
Short-tail specialty and casualty	15,614	9.1 %	40,510	15.3 %
Total	\$ 171,150	100.0 %	\$ 264,128	100.0 %

Line of business	2012		2011	
	Gross premiums written	Percentage of total	Gross premiums written	Percentage of total
Property catastrophe	\$ 233,096	68.3 %	\$ 372,256	60.4 %
Property	66,666	19.5 %	119,023	19.3 %
Short-tail specialty and casualty	41,616	12.2 %	125,524	20.3 %
Total	\$ 341,378	100.0 %	\$ 616,803	100.0 %

Geographic area of risk insured (1)	2012		2011	
	Gross premiums written	Percentage of total	Gross premiums written	Percentage of total
Caribbean	\$ 7,484	4.4 %	\$ 1,623	0.6 %
Europe	18,744	11.0 %	13,187	5.0 %
Japan and Australasia	21,965	12.8 %	27,805	10.5 %
North America	108,139	63.2 %	177,557	67.2 %
Worldwide risks (2)	13,491	7.9 %	32,706	12.4 %
Other	1,327	0.7 %	11,250	4.3 %
Total	\$ 171,150	100.0 %	\$ 264,128	100.0 %

Geographic area of risk insured (1)	2012		2011	
	Gross premiums written	Percentage of total	Gross premiums written	Percentage of total

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Caribbean	\$	8,984	2.6 %	\$	3,416	0.6 %
Europe		68,003	19.9 %		89,702	14.5 %
Japan and Australasia		33,062	9.7 %		70,304	11.4 %
North America		179,558	52.6 %		301,576	48.9 %
Worldwide risks (2)		43,101	12.6 %		125,333	20.3 %
Other		8,670	2.6 %		26,472	4.3 %
Total	\$	341,378	100.0 %	\$	616,803	100.0 %

(1)Except as otherwise noted, each of these categories includes contracts that cover risks located primarily in the designated geographic area.

(2)Includes contracts that cover risks in two or more geographic zones.

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## Premiums Ceded

In the normal course of our business, we purchase reinsurance in order to manage our exposures. The amount and type of reinsurance that we enter into is dependent on a variety of factors, including the cost of a particular reinsurance cover, our appetite and capacity to write certain risks and the nature of our gross premiums written during a particular period.

The majority of these contracts are excess-of-loss contracts covering one or more lines of business or quota share reinsurance with respect to specific lines of business. We also purchase protection through catastrophe bond structures, Montana Re, and industry loss warranty (“ILW”) policies which provide coverage for certain losses provided they are triggered by events exceeding a specified industry loss size. Reinsurance purchases to date have represented prospective cover; that is, ceded reinsurance purchased to protect against the risk of future losses as opposed to covering losses that have already been incurred but have not been paid.

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, capital levels, evolving industry-wide capital requirements, increased competition, and other considerations.

Below is a summary of our underwriting results and ratios for the three months ended June 30, 2012 and 2011:

	For the three months ended June 30,			
	2012	2011	\$ Change	% Change
Property catastrophe reinsurance	\$ 126,755	\$ 170,394	\$ (43,639)	(25.6)%
Property reinsurance	28,781	53,224	(24,443)	(45.9)%
Short tail specialty and casualty reinsurance	15,614	40,510	(24,896)	(61.5)%
Gross premiums written	171,150	264,128	(92,978)	(35.2)%
Premiums ceded	(6,285)	(44,409)	38,124	(85.8)%
Net premiums written	164,865	219,719	(54,854)	(25.0)%
Net premiums earned	102,499	118,620	(16,121)	(13.6)%
Other related income	909	731	178	24.4 %
Loss and loss adjustment expenses	(55,483)	(96,490)	41,007	(42.5)%
Acquisition costs	(22,113)	(25,613)	3,500	(13.7)%
General and administrative expenses	(18,822)	(19,744)	922	(4.7)%
Underwriting income (loss)	\$ 6,990	\$ (22,496)	\$ 29,486	131.1 %
Loss ratio	54.1 %	81.3 %		
Acquisition cost ratio	21.6 %	21.6 %		
General and administrative expense ratio	18.4 %	16.6 %		
Combined ratio	94.1 %	119.5 %		

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The increase in net underwriting results is the result of the lack of significant loss events during the second quarter of 2012 compared to the same period in 2011 (New Zealand earthquake of June 2011 and U.S. tornadoes), offset by a significant reduction in gross premiums written and net premiums earned, which is in line with our current underwriting strategy.

- The decrease in gross premiums written for all lines of business is a result of an overall decrease in our risk appetite and in our shareholder's equity following the significant worldwide losses we sustained in 2011. During the three months ended June 30, 2012, we recorded \$3.9 million of gross reinstatement premiums compared to \$5.8 million recorded for the same period in 2011.
- The decrease in ceded premiums is primarily related to higher reinstatement premiums incurred in 2011 on our ceded reinsurance due to loss activity and the increased level of reinsurance purchases after the loss events during the first quarter of 2011.
- The decrease in the loss ratio compared to the same period in 2011 is primarily due to more significant losses from catastrophic events in the prior period, which included the New Zealand earthquake of \$18.5 million and U.S. tornadoes of \$19.4 million. Losses are net of retrocession but exclude reinstatement premiums.
- Each quarter we revisit our loss estimates for previous catastrophe events. During the quarter ended June 30, 2012, based on updated estimates provided by clients and brokers, we recorded net favorable developments of \$1.4 million for prior accident years. During the second quarter of 2011, the net positive developments for prior catastrophe events were \$12.8 million.

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- The acquisition cost ratio compared to the same period in 2011 has remained stable.
- The decrease in general and administrative expenses is primarily the result of expense reduction initiatives in accordance with our overall decrease in underwriting activities, partially offset by lower staff compensation accrual in the same period in 2011 as a result of the significant underwriting loss.

Below is a summary of the underwriting results and ratios for the six months ended June 30, 2012 and 2011:

	2012	For the six months ended June 30, 2011	\$ Change	% Change
Property catastrophe reinsurance	\$ 233,096	\$ 372,256	\$ (139,160)	(37.4)%
Property reinsurance	66,666	119,023	(52,357)	(44.0)%
Short tail specialty and casualty reinsurance	41,616	125,524	(83,908)	(66.8)%
Gross premiums written	341,378	616,803	(275,425)	(44.7)%
Premiums ceded	(91,184)	(163,159)	71,975	(44.1)%
Net premiums written	250,194	453,644	(203,450)	(44.8)%
Net premiums earned	216,244	319,673	(103,429)	(32.4)%
Other related income	2,744	1,003	1,741	173.6 %
Loss and loss adjustment expenses	(121,932)	(399,489)	277,557	(69.5)%
Acquisition costs	(44,766)	(63,684)	18,918	(29.7)%
General and administrative expenses	(40,683)	(35,819)	(4,864)	13.6 %
Underwriting income (loss)	\$ 11,607	\$ (178,316)	\$ 189,923	106.5 %
Loss ratio	56.4 %	125.0 %		
Acquisition cost ratio	20.7 %	19.9 %		
General and administrative expense ratio	18.8 %	11.2 %		
Combined ratio	95.9 %	156.1 %		

- The increase in net underwriting results is the result of the lack of significant loss events in 2012 compared to the same period in 2011 (Australian floods, cyclone Yasi, New Zealand earthquakes of February 2011 and June 2011, Japan earthquake and tsunami, and U.S. tornadoes), offset by a significant reduction in gross premiums written and net premiums earned, which is in line with our current underwriting strategy.
- The decrease in gross written premiums for all lines of business is a result of an overall decrease in our risk appetite and in our shareholder's equity following the significant worldwide losses we sustained in 2011. During the six months ended June 30, 2012, we recorded \$11.3 million of gross reinstatement premiums compared to \$17.8 million recorded for the same period in 2011. The decrease in reinstatement premiums was due to lower catastrophe losses in the current period.
- The decrease in ceded premiums is primarily related to higher reinstatement premiums incurred in 2011 on our ceded reinsurance due to loss activity and the increased level of reinsurance purchases after the loss events during the first quarter of 2011.

- The decrease in the loss ratio compared to the same period in 2011 is primarily due to more significant losses from catastrophic events in the prior period, including net incurred losses related to the Australian floods (\$27.2 million), cyclone Yasi (\$29.8 million), New Zealand earthquake of February 2011 (\$100.8 million), the Japan earthquake and tsunami (\$99.1 million), New Zealand earthquake of June 2011 (\$18.5 million) and the U.S. tornadoes (\$19.4 million). Losses are net of retrocession but exclude reinstatement premiums.
- Each quarter we revisit our loss estimates for previous catastrophe events. During the six months ended June 30, 2012, based on updated estimates provided by clients and brokers, we recorded net adverse developments of \$6.1 million, related to cumulative prior accident years. In addition, we undertook our scheduled first quarter review of actuarial reserving assumptions. As a result of revised development factors for non-cat business based in part on experience, we recorded \$7.0 million of negative reserves development.

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- The increase in general and administrative expenses is primarily the result of staff compensation accrual and performance based compensation returning to more typical levels in the current period as compared to levels in the same period in 2011, which were adjusted downward as a result of the significant underwriting loss.

Income from Discontinued Operations

Income from discontinued operations includes the financial results of our former reportable segments, Lloyd's (for all periods presented) and Island Heritage (for all periods presented up to and including March 31, 2012). Included in income from discontinued operations for the six months ended June 30, 2012 is underwriting income of \$8.6 million, compared to underwriting losses of \$3.6 million for the same period in 2011. The \$12.2 million increase in underwriting income is primarily attributable to more significant catastrophic events during 2011 compared to 2012.

In addition, as of June 30, 2012, we had liabilities associated with discontinued operations of \$393.8 million, all associated with our Lloyd's former reportable segment. Although we account for the business comprising our former Lloyd's and Island Heritage reportable segments as discontinued operations, we owned the Island Heritage business until completing its sale on April 5, 2012, and we will continue to own the Lloyd's business and be subject to the risks associated with that business until the Lloyd's divestiture is complete.

Investment Results

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.

The total return on our investment portfolio, excluding the noncontrolling interests in the investment portfolio, comprises investment income and realized and unrealized gains and losses on investments.

	For the three months ended June 30,			For the six months ended June 30,		
	2012	2011	% Change	2012	2011	% Change
Investment portfolio return	0.5 %	0.3 %	0.2 %	2.4 %	1.3 %	1.1 %

Net investment income

Net investment income is derived from interest earned on investments, reduced by investment management and custody fees. We allocate expenses directly related to investment activities to investment income.

The following tables set forth net investment income for the three months ended June 30, 2012 and 2011:

	For the three months ended June 30,		
	2012	2011	\$ Change
Cash and cash equivalents	\$ 214	\$ 385	\$ (171)
Fixed maturity investments	2,177	12,861	(10,684)
Short term investments	243	222	21
Other investments	2,160	(29)	2,189
Investment expenses	(928)	(1,139)	211



Net investment income	\$	3,866	\$	12,300	\$	(8,434)
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- The decrease in net investment income is primarily due to lower invested assets and the change in asset allocation during the quarter.
- The increase in investment income from other investments is primarily due to the positive performance of the investment funds.

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The following table sets forth net investment income for the six months ended June 30, 2012 and 2011:

	For the six months ended June 30,		
	2012	2011	\$ Change
Cash and cash equivalents	\$ 484	\$ 779	\$ (295)
Fixed maturity investments	7,944	22,669	(14,725)
Short term investments	365	428	(63)
Other investments	2,148	(88)	2,236
Investment expenses	(2,008)	(2,290)	282
Net investment income	\$ 8,933	\$ 21,498	\$ (12,565)

- The overall decrease in net investment income is primarily due to lower invested assets, the change in asset allocation and lower interest rates during the period.
- The increase in investment income from other investments is primarily due to the positive performance of the investment funds.

#### Net realized and unrealized gains and losses – investments

Net realized and unrealized gains and losses – investments comprises fixed maturities, equities, other investments, and investment portfolio derivatives. We enter into investment portfolio derivatives including global equity futures, global bond futures, commodity futures and TBAs. We enter into index futures contracts to gain or reduce our exposure to an underlying asset or index. We also purchase TBAs as part of our investing activities. We enter into interest rate futures in order to manage portfolio duration and interest rate risk. Exposure to these instruments is managed based on guidelines established by management and is approved by the Board.

The following table is a breakdown of net realized and unrealized (losses) gains – investments for the three months ended June 30, 2012 and 2011:

	For the three months ended June 30,		
	2012	2011	\$ Change
Net realized gains on fixed maturity investments	\$ 14,589	\$ 22,615	\$ (8,026)
Net unrealized (losses) gains on fixed maturity investments	(27,417)	3,328	(30,745)
Net realized losses on equity investments	-	(845)	845
Net unrealized (losses) gains on equity investments	(15)	781	(796)
Net realized and unrealized gains (losses) on derivative instruments - investments (see table below)	15,510	(34,096)	49,606
Net realized and unrealized gains on other investments	2,698	312	2,386
	\$ 5,365	\$ (7,905)	\$ 13,270

Net realized and unrealized gains (losses) -  
investments

	For the three months ended June 30,		
	2012	2011	\$ Change
Futures contracts	\$ (74)	\$ (16,554)	\$ 16,480
Foreign currency forward contracts	15,584	(17,542)	33,126
Net realized and unrealized gains (losses) on derivative instruments - investments	\$ 15,510	\$ (34,096)	\$ 49,606

- The change in net realized and unrealized on fixed maturity investments is primarily due to the change in asset allocation and to foreign currency impact on the portfolio.
- The change in net realized and unrealized on other investments is primarily due to the positive performance on investment funds.

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- The change in net realized and unrealized on futures contracts is primarily due to less exposure to risky assets during 2012.
- The change in net realized and unrealized on foreign currency forward contracts is related to the currency hedges on non-U.S. dollar bonds and is offset by net realized and unrealized losses on the fixed maturity investments.

The following table is a breakdown of the net realized and unrealized gains - investments for the six months ended June 30, 2012 and 2011:

	For the six months ended June 30,		
	2012	2011	\$ Change
Net realized gains on fixed maturity investments	\$ 23,186	\$ 36,708	\$ (13,522)
Net unrealized (losses) gains on fixed maturity investments	(11,487)	22,470	(33,957)
Net realized losses on equity investments	-	(845)	845
Net unrealized (losses) gains on equity investments	(18)	750	(768)
Net realized and unrealized gains (losses) on derivatives instruments - investments (see table below)	3,205	(60,506)	63,711
Net realized and unrealized gains on other investments	8,582	4,289	4,293
Net realized and unrealized gains - investments	\$ 23,468	\$ 2,866	\$ 20,602

	For the six months ended June 30,		
	2012	2011	\$ Change
Futures contracts	\$ 179	\$ (8,986)	\$ 9,165
Foreign currency forward contracts	3,026	(51,518)	54,544
Mortgage-backed securities TBA	-	(2)	2
Net realized and unrealized gains (losses) on derivatives instruments - investments	\$ 3,205	\$ (60,506)	\$ 63,711

- The change in net realized and unrealized on fixed maturity investments is primarily due to the tightening of credit spreads, to the change in asset allocation and to higher foreign currency impact on the portfolio.
- The change in net realized and unrealized on other investments is primarily due to the positive performance on investment funds.
- The change in net unrealized and unrealized on futures contracts is primarily due to less exposure to risky assets during 2012.
- The change in net realized and unrealized on foreign currency forward contracts is related to the currency hedges on non-U.S. dollar bonds and is offset by net realized and unrealized gains on the fixed maturity investments.

Treasury Hedging and Other

Net realized and unrealized gains and losses – other

Our policy is to hedge the majority of our currency exposure with derivative instruments such as currency swaps and foreign currency forward contracts.

Currency swaps and foreign currency forward contracts are used to hedge the economic currency exposure of our investment in foreign subsidiaries and to hedge operational balances such as premiums receivable, loss reserves and the portion of our long term debt issued in Euros.

Reinsurance derivatives relate to ILWs that are structured as derivative transactions. The amounts shown in the tables below are premiums earned on ILWs.

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The following tables are a breakdown of net realized and unrealized (losses) gains – other for the three and six months ended June 30, 2012 and 2011:

	For the three months ended June 30,		
	2012	2011	\$ Change
Currency swaps	\$ (937)	\$ 467	\$ (1,404)
Foreign currency forward contracts	(4,053)	13,519	(17,572)
Net realized and unrealized (losses) gains - other	\$ (4,990)	\$ 13,986	\$ (18,976)

- The net realized and unrealized losses associated with the currency swaps are due to currency fluctuations, which are partially offset by net gains recorded through the balance sheet currency revaluations on the foreign currency long term debt.
- The net realized and unrealized losses associated with foreign currency forward contracts are due to currency fluctuations, which are partially offset by net gains recorded through the balance sheet currency revaluations on reinsurance balances.

	For the six months ended June 30,		
	2012	2011	\$ Change
Currency swaps	\$ (509)	\$ 1,547	\$ (2,056)
Foreign currency forward contracts	1,902	11,508	(9,606)
Reinsurance derivatives	-	241	(241)
Net realized and unrealized gains - other	\$ 1,393	\$ 13,296	\$ (11,903)

- The net realized and unrealized losses associated with the currency swaps are due to currency fluctuations, which are partially offset by net gains recorded through balance sheet currency revaluations on the foreign currency long term debt.
- The net realized and unrealized losses associated with foreign currency forward contracts are due to currency fluctuations, which are partially offset by net losses recorded through balance sheet currency revaluations on reinsurance balances.
  - The last reinsurance derivative expired in 2011 and we have not written any further derivatives.

## Interest Expense

Interest expense consists of interest due on outstanding debt securities and the amortization of debt offering expenses. Interest expense was \$3.0 million and \$5.9 million, respectively, for the three and six months ended June 30, 2012, compared to \$2.9 million and \$5.7 million, respectively, for the three and six months ended June 30, 2011.

## Foreign Exchange

For the three and six months ended June 30, 2012, we experienced net foreign exchange gains of \$3.4 million and net foreign exchange losses of \$0.9 million, respectively, compared to net foreign exchange losses of \$27.4 million and \$37.0 million, respectively, for the three and six months ended June 30, 2011. This net change is primarily due to the impact of the strengthening U.S. dollar on our net liabilities. Net realized and unrealized gains and losses on derivatives used to hedge those balances are included in "Net realized and unrealized gains (losses) – other" in the unaudited condensed consolidated statements of operations.

We designated foreign currency forwards with notional contractual value of \$51.9 million and \$51.6 million as hedging instruments, which had a fair value of \$(1.1) million and \$(0.5) million at June 30, 2012 and December 31, 2011, respectively. During the three and six months ended June 30, 2012 and 2011, we recorded \$3.1 million and \$1.0 million, respectively, of realized and unrealized gains, directly into comprehensive income as part of the cumulative translation adjustment for the effective portion of the hedge.

#### Income Tax Expense

We have 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 our subsidiaries are subject to tax are South Africa, Canada, India, Switzerland, United Kingdom, and the U.S. However, since the majority of our income to date has been earned in Bermuda where we are exempt from income tax, the impact of income taxes to date has been minimal.

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During the three and six months ended June 30, 2012, income tax expense was \$0.2 million and \$0.3 million, respectively, compared to income tax recovery of \$0.8 million and \$1.1 million, respectively, for the three and six months ended June 30, 2011.

## Noncontrolling Interest

The following table is the breakdown of income attributable to noncontrolling interest in the unaudited condensed consolidated statements of operations into its various components:

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
Income attributable to Island Heritage	\$ -	\$ 1,197	\$ 1,135	\$ 1,465
Income attributable to Mont Fort	-	-	-	556
Income attributable to noncontrolling interest	\$ -	\$ 1,197	\$ 1,135	\$ 2,021

The portions of Mont Fort's net income and shareholders' equity attributable to the preferred shareholders and Island Heritage's net income and shareholders' equity attributable to minority shareholders are recorded as noncontrolling interest in accordance with the FASB ASC Topic on Consolidation. Effective March 25, 2011, upon the final redemption of Mont Fort preferred shares, there is no longer a noncontrolling interest in Mont Fort. Effective April 5, 2012, upon final disposal of the former Island Heritage reportable segment, there is no longer a noncontrolling interest in Island Heritage.

## Comprehensive Income (Loss)

The following table is the breakdown of comprehensive income (loss) in the unaudited condensed consolidated statements of operations into its various components:

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
Net income (loss)	\$ 13,490	\$ (19,013)	\$ 53,810	\$ (179,409)
Change in currency translation adjustment	(4,669)	873	(132)	3,750
Change in defined benefit pension plan obligation	136	(158)	(72)	(158)
Comprehensive income (loss)	8,957	(18,298)	53,606	(175,817)
Less: Comprehensive loss attributable to noncontrolling interest	-	(1,197)	(1,135)	(2,021)
Comprehensive income (loss) attributable to Flagstone	\$ 8,957	\$ (19,495)	\$ 52,471	\$ (177,838)

The currency translation adjustment is a result of the translation of our foreign subsidiaries into U.S. dollars, net of transactions designated as hedges of net foreign investments. We have entered into certain foreign currency forward



contracts that we have designated as hedges in order to hedge our net investment in foreign subsidiaries. To the extent that the contracts are 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. For further information, on foreign currency forward contracts, please refer to the Foreign Exchange section noted above.

#### Financial Condition, Liquidity, and Capital Resources

##### Financial Condition

Our investment portfolio on a risk basis, at June 30, 2012, comprised 93.9% fixed maturities, short-term investments and cash and cash equivalents with 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 investment funds, which represent 5.0% of our total investments and cash and cash equivalents at June 30, 2012, do not trade in active markets and are subject to redemption provisions that prevent us from converting them into cash immediately. During the quarter, we made changes to our investment portfolio allocations due to continued economic uncertainty in the global markets. Our investment portfolio was repositioned to have shorter duration and higher credit quality. We continuously monitor the economic environment and global markets and will consider appropriate changes to the investment portfolio allocations if and when warranted.

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At June 30, 2012 and December 31, 2011, all of the fixed maturity investments in our investment portfolio were rated investment-grade (BBB- or higher) by Standard & Poor's (or an equivalent rating by another rating agency) with an average rating of AAA and AA, respectively.

The average duration of our investment portfolio was 0.3 years at June 30, 2012 and 1.8 years at December 31, 2011.

Other investments as at June 30, 2012, amounted to \$142.4 million compared to \$125.5 million at December 31, 2011. At June 30, 2012, the other investments comprised \$71.8 million in catastrophe bonds and \$68.2 million in investment funds, which are recorded at fair value and our equity method investment of \$2.4 million. The increase in other investments during the first six months of 2012 is principally related to additional investments in investment funds and catastrophe bonds along with positive performance on investment funds partially offset by negative performance in the catastrophe bonds.

		June 30, 2012	As at December 31, 2011
Investment funds	\$	68,235	\$ 59,278
Catastrophe bonds		71,762	64,016
Equity method investment		2,446	2,158
Total	\$	142,443	\$ 125,452

The net payable for investments purchased at June 30, 2012, was \$0.1 million, compared to a net payable for investments purchased of \$6.2 million at December 31, 2011. Net receivables and payables for investments are a result of timing differences only, as investments are accounted for on a trade date basis.

See Note 5 "Investments" to the unaudited condensed consolidated financial statements for further details on amortized cost, gross unrealized gains and losses, and rating and maturity distributions.

Liquidity

Cash flows from operations for the six months ended June 30, 2012 used \$181.0 million, as compared to providing \$95.2 million during the same period in 2011. This decrease in cash flows from operations was primarily related to decreased loss and loss adjustment expense reserves resulting from the volume of claims paid on the 2011 loss events, partially offset by higher net income in the current period due to the absence of significant loss events during the six months ended June 30, 2012. Because a large portion of the coverages we provide 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 distributions to shareholders, share related transactions and the issuance or repayment of debt. During the six months ended June 30, 2012, net cash of \$7.0 million was used in financing activities, compared to \$52.3 million for the same period in 2011. For the six months ended June 30, 2012, the net cash used in financing activities related principally to the payment of distributions. For the six months ended June 30, 2011, the net cash used in financing activities related principally to the redemption of preferred shares in Mont Fort High Layer.

We may incur additional indebtedness in the future if we determine that it would improve the efficiency of our capital structure.

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

To date, 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 divestiture of Island Heritage did not have a significant impact on our operation's needs for liquidity. In addition, with reference to "Recent Developments" above, as of the date of this Quarterly Report, we do not anticipate the divestiture of Lloyd's to have a significant impact on our operation's needs for liquidity.

In the current financial environment, it may be difficult for the insurance industry generally, and us in particular, to raise additional capital when required, on acceptable terms or at all. Cash and cash equivalents were \$186.3 million at June 30, 2012. On October 24, 2011, A.M. Best Co. commented that the Company's recent restructuring announcement has not changed the issuer credit ratings ("ICRs") of "a-" of Flagstone Reassurance Suisse S.A. (Martigny, Switzerland), Island Heritage Insurance Company Ltd. (Cayman Islands) and Flagstone Alliance Insurance and Reinsurance PLC (Limassol, Cyprus) as well as the ICR of "bbb-" of Flagstone

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Reinsurance Holdings S.A. (Luxembourg), nor has the announcement changed the indicative debt ratings of “bb” on preferred stock, “bb+” on subordinated debt and “bbb-” on senior debt for securities available under the Company’s shelf registration statement. A.M. Best Co. noted that the outlook for all ratings, with the exception of Island Heritage Insurance Company Ltd., remains negative. On April 4, 2012, after the Company announced that it had entered into definitive agreements for the sale of its Lloyd’s business and Island Heritage, A.M. Best Co. commented these ICRs remain unchanged and that the outlook for all ratings remains negative. On May 18, 2012, A.M. Best Co. again commented that these ICRs remain unchanged and that the outlook for all ratings remains negative. The Company’s ICRs, including those of its wholly owned subsidiaries, are important to maintaining the Company’s liquidity. A reduction in these credit ratings, the continued negative outlook or a failure to resolve the negative outlook could reduce the Company’s access to debt markets or materially increase the cost of issuing debt, trigger additional collateral or funding requirements, and decrease the number of counterparties willing or permitted, contractually or otherwise, to do business with or lend to the Company, thereby curtailing the Company’s business operations and reducing its profitability.

## Capital Resources

Our total capital resources at June 30, 2012 and December 31, 2011 were as follows:

		As at	
		June 30, 2012	December 31, 2011
Long term debt	\$	250,202	\$ 250,575
Common shares		845	845
Common shares held in treasury		(150,202)	(160,448)
Additional paid-in capital		857,714	872,819
Accumulated other comprehensive loss		(12,788)	(12,584)
Retained earnings		141,091	88,416
Total capital	\$	1,086,862	\$ 1,039,623

The movement in both common shares held in treasury and additional paid-in capital during the six months ended June 30, 2012, arises from the use of treasury shares to settle vested stock based compensation grants.

For the six months ended June 30, 2012, accumulated other comprehensive loss arose from the changes in currency translation adjustment of \$(0.1) million and the defined benefit pension plan obligation of \$(0.1) million.

## Letter of credit facilities

On August 31, 2011, Flagstone Suisse and Flagstone Capital Management Luxembourg SICAF – FIS (“FCML”) entered into a \$200.0 million secured committed letter of credit facility with Barclays Bank Plc (the “Barclays Facility”). The Barclays Facility is for letters of credit with a maximum tenor of 15 months and is used to support the reinsurance obligations of the Company. As of June 30, 2012, \$46.0 million had been drawn under the Barclays Facility, and the drawn amount was secured by \$48.4 million of fixed maturity investments from the Company’s investment portfolio. The Barclays Facility replaced a \$200.0 million credit facility with Barclays Bank Plc which commenced on March 5, 2009.

On April 28, 2010, Flagstone Suisse and FCML entered into a secured \$450.0 million standby letter of credit facility with Citibank Europe Plc (the “Citi Facility”). The Citi Facility comprised a \$225.0 million facility for letters of credit with a maximum tenor of 15 months, to be used to support reinsurance obligations of the Company, and a \$225.0

million facility for letters of credit drawn in respect of Funds at Lloyd's with a maximum tenor of 60 months. On December 21, 2010, the Citi Facility was amended to increase the amount available under the facility by \$100.0 million to \$550.0 million, with all the terms and conditions remaining unchanged. The Citi Facility now comprises a \$275.0 million facility for letters of credit with a maximum tenor of 15 months, to be used to support reinsurance obligations of the Company, and a \$275.0 million facility for letters of credit drawn in respect of Funds at Lloyd's with a maximum tenor of 60 months. As at June 30, 2012, \$507.5 million had been drawn under the Citi Facility, and the drawn amount of the facility was secured by \$554.7 million of fixed maturity investments from the Company's investment portfolio. The Citi Facility replaced a \$450.0 million credit facility with Citibank Europe Plc which commenced on January 22, 2009.

These facilities are used to provide security to reinsureds and for Funds at Lloyd's, and they are fully collateralized by the Company, to the extent of the letters of credit outstanding at any given time.

The divestiture of Island Heritage did not have a significant impact on our capital resources. In addition, we do not anticipate any significant impact on our capital resources as a result of the divestiture of Lloyd's discussed in "Recent Developments" above. However, the Lloyd's divestiture will result in a reduction in the utilization of our letter of credit facilities.

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Restrictions and Specific Requirements

Luxembourg

We do not conduct the business of an insurer or reinsurer in Luxembourg and therefore are not required to be registered with the Commissariat aux Assurances, which is the authority in Luxembourg that regulates insurers and reinsurers.

Under Luxembourg Law, our shareholders may declare dividends at a general meeting of shareholders through the passage of an ordinary resolution, but, in accordance with our Articles, the dividend may not exceed the amount recommended by our Board. Dividends may only be declared from our distributable reserves. In accordance with Luxembourg Law, no distributions to shareholders may be made when, on the closing date of the relevant financial year, the net assets as set out in the annual accounts are, or would be following such a distribution, lower than the subscribed capital plus the reserves that may not be distributed under Luxembourg Law or in accordance with our Articles. The amount of a distribution to shareholders may not exceed the amount of profits at the end of the last financial year plus any profits carried forward and any amounts drawn from reserves which are available for that purpose, less any losses carried forward and sums to be placed to reserve in accordance with the Luxembourg Law or in accordance with the Articles.

Subject to Luxembourg Company Law, our Board may declare interim dividends. The declaration of interim dividends is subject to the approval of shareholders at the next general meeting. Where the payments made on account of interim dividends exceed the amount of dividends subsequently approved by shareholders at the general meeting, they shall, to the extent of the overpayment, be deemed to have been paid on account of the next dividend. Our Articles allow for the declaration of interim dividends, but any payment of interim dividends is subject to the conditions that: (i) interim accounts are drawn up showing that the funds available for distribution are sufficient; (ii) the amount to be distributed may not exceed total profits made since the end of the last financial year for which the accounts have been approved, plus any profits carried forward and sums drawn down from reserves available for this purpose, less losses carried forward any sums to be placed to reserve pursuant to the requirements of the law or our Articles; (iii) the decision of our Board to distribute an interim dividend may not be taken more than two months after the date at which the interim accounts have been made up; (iv) in their report, our Board of Directors and the statutory auditor shall verify whether the above conditions have been satisfied.

Certain of our investment management activities are based in Luxembourg and managed through Flagstone Capital Management Luxembourg SICAF – FIS (“FCML”). FCML is a closed-end investment fund and is regulated by the Luxembourg Commission de Surveillance du Secteur Financier. In accordance with the various documents governing the operation of FCML, a general meeting determines how the profits (including net realized capital gains) of FCML are disposed of and may from time to time declare, or authorize the Board of Directors of FCML to declare dividends, provided however that the capital of FCML including issue premiums does not fall below €1,250,000 or the equivalent thereof in any currency in which shares in FCML are issued. Dividends may also be paid out of net unrealized capital gains after deduction of realized losses. The Board of Directors of FCML is further authorized to pay interim dividends subject to the relevant provisions of Luxembourg law.

Switzerland

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.

#### Bermuda

Flagstone Suisse is licensed as a Class 4 insurer in Bermuda through its branch office. 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.

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The Company established a Luxembourg SICAF fund, FCML, on September 8, 2008 to manage the group's investments in Luxembourg. FCML is a wholly owned subsidiary of Flagstone Suisse. This structure offers the group many advantages such as the benefits of centralized investment management, tax and regulatory efficiencies. For purposes of the Swiss Solvency Test, the investment in FCML is consolidated in Flagstone Suisse's accounts, as approved by FINMA since 2008.

In preparing the stand alone Bermuda statutory financial statements of Flagstone Suisse, FCML is recorded as an investment in affiliate on the balance sheet and as such does not automatically qualify as a relevant asset for the purposes of the liquidity ratio.

The Company applied to the Bermuda Monetary Authority (the "BMA") for FCML to qualify as a relevant asset for the purposes of meeting the 2011 liquidity ratio requirements and on March 13, 2012 the application was approved by the BMA, followed by the receipt of official documentation on May 1, 2012. Flagstone Suisse is required to file statutory financial statements annually with the BMA by April 30.

In addition, each Class 4 insurer must maintain its capital at a level equal to its enhanced capital requirement ("ECR") which is established by reference to the Bermuda Solvency Capital Requirement ("BSCR") model which came into force in 2008 to assist the BMA to better assess the adequacy of a Class 4 insurer's capital.

Alternatively, under the Insurance Act, insurers may, subject to the terms of the Insurance Act and to the BMA's oversight, elect to utilize an approved internal capital model to determine regulatory capital. The BMA believes that use of an internal model to substantiate the required regulatory capital requirement may in many circumstances better reflect a specific insurer's particular business profile than a market-wide regulatory model. An insurer's internal model must satisfy certain criteria to be approved for the determination of regulatory capital. In either case, the ECR shall at all times equal or exceed the Class 4 insurer's Minimum Solvency Margin and may be adjusted in circumstances where the BMA concludes that the insurer's risk profile deviates significantly from the assumptions underlying its ECR or the insurer's assessment of its risk management policies and practices used to calculate the ECR applicable to it.

In 2009, the BMA launched its Bermuda Insurance Solvency Framework, which is designed to enable Bermuda to achieve "equivalence" with Solvency II. As of the date of this Quarterly Report, the impact of this initiative is currently being monitored by the Company.

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.

### South Africa

Flagstone Africa is regulated by the Financial Services Board ("FSB") and is licensed to operate as a reinsurer in South Africa 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.



United Kingdom

Our discontinued operations FSML and Syndicate 1861 are regulated by the Financial Services Authority (“FSA”) in the U.K. 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”.

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 cooperation on supervision and enforcement.

FSML’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).

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Solvency II

The European Parliament passed the Solvency II directive in April 2009, to establish a revised set of European Union (EU) wide capital requirements and risk management standards. All (re)insurers, including Lloyd's and its managing agents, within the EU need to be compliant with Solvency II by January 1, 2014.

Flagstone's existing risk management framework and mechanisms closely mirror the requirements for Solvency II. Since its inception, Flagstone has invested in its internal model that generates the Group's risk profile and this model is also used to calculate the internal capital requirements for Lloyd's. Flagstone is working closely with Lloyd's to ensure full compliance with the regulations. Flagstone believes that Solvency II will have a positive impact on its operations and risk management framework.

Off Balance Sheet Arrangements

Montana Re is a special purpose reinsurer established in the Cayman Islands and was formed as a program structure enabling further issuance of additional series of notes in the future. During 2009, we entered into a reinsurance agreement with Montana Re that provides us with \$175.0 million of protection for certain losses from global catastrophe events. During 2010, we entered into an additional reinsurance agreement with Montana Re, which inceptioned on January 1, 2011, that provides us with \$210.0 million of protection for certain losses from global catastrophe events. These bonds have recently been downgraded by the relevant rating agencies to reflect the increased likelihood of attachments due to recent industry model changes.

We have determined that Montana Re has the characteristics of a variable interest entity that are addressed by the Consolidation Topic of the FASB ASC. In accordance with the Consolidation Topic, Montana Re is not consolidated because we are not the primary beneficiary.

We are not party to any transaction, agreement or other contractual arrangement to which a Flagstone affiliated unconsolidated entity is a party, other than those noted above with Montana 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 above "Financial Condition, Liquidity and Capital Resources - 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 an enterprise-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 are exposed principally 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. Fluctuations in interest rates have a direct impact on the market valuation of our fixed maturity portfolio. As interest rates rise, the market value of our fixed maturity portfolio falls there is a 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 maturity portfolio increases and we have reinvestment risk since funds reinvested may 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 which can be tailored to the anticipated cash outflow characteristics of our reinsurance liabilities. In addition, from time-to-time, we 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 June 30, 2012, the impact on our fixed maturity investments and 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 0.3%, or approximately \$3.4 million. As at June 30, 2012, the impact on our fixed maturity investments, 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 0.1%, or approximately \$1.7 million. As at December 31, 2011, the impact on our fixed maturity investments and 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 1.7%, or approximately \$22.9 million. As at December 31, 2011, the impact on our fixed maturity investments and 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 1.6%, or approximately \$21.7 million.

We use interest rate futures to manage the duration and the interest rate risk of our investment portfolio. As at June 30, 2012, we did not hold any interest rate futures contracts, as the positions were closed as part of changes made to our investment portfolio. The interest rate futures contracts held were for three month exposure to U.S. and Euro interest rates, and we held short positions which reduced the duration of our portfolio.

As at June 30, 2012, we held \$312.3 million, or 30.3% of our fixed maturity portfolio in asset-backed and mortgage-backed securities. As at December 31, 2011, we held \$232.8 million, or 20.3%, of our fixed maturity portfolio in asset-backed and mortgage-backed securities. We did not hold any sub-prime securities at June 30, 2012 and December 31, 2011. 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, we would also be exposed to reinvestment risk, as cash flows received by us could be accelerated and would 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 and index-linked futures. The total of such exposure as at June 30, 2012 and December 31, 2011 was \$0.1 million and \$7.8 million, respectively. The fair value of these positions as at June 30, 2012 and December 31, 2011 amounted to \$0.1 million and \$(0.1) million, respectively, and was recorded in equity investments and other assets and other liabilities. For the three and six months ended June 30, 2012, we recorded net realized and unrealized gains of \$nil and \$0.9 million, respectively, in net realized and unrealized gains – investments as compared to losses of \$5.8 million and \$0.9 million, respectively, for the three and six months ended June 30, 2011.

#### Credit Risk

We have exposure to credit risk primarily as a holder of fixed maturity investments. 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 June 30, 2012, our fixed maturity investments consisted of investment grade securities with an average rating of AAA. We believe this high-quality portfolio reduces our exposure to credit risk on fixed income investments to an acceptable level. We have included credit rating information with respect to our investment portfolio because it enhances the reader's understanding of its composition and consistency with our investment philosophy.

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To a lesser extent, we also have credit risk exposure as a party to over-the-counter derivative instruments. These derivative instruments include foreign currency forward contracts, currency swaps and reinsurance derivatives. 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.

In addition, we have exposure to credit risk as it relates to our insurance and reinsurance balances receivable. Premium balances receivable from our clients at June 30, 2012 and December 31, 2011, were \$273.7 million and \$236.4 million, respectively, including balances both currently due and accrued. We believe 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 ceding. Since our inception in October 2005, we have recorded \$4.2 million in bad debt expenses related to our insurance and reinsurance balances receivable.

We purchase retrocessional reinsurance and we require our reinsurers to have adequate financial strength or collateralize their exposures. We evaluate the financial condition of our reinsurers and monitor our 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 our underwriting risks. Catastrophe bonds are selected by our reinsurance underwriters however they are held in our investment portfolio as floating rate bonds for performance purposes.

## Foreign Currency Risk

We use foreign currency forward contracts and currency swaps to manage currency exposure. The net notional exposure of foreign currency forward contracts in U.S. dollars as at June 30, 2012 and December 31, 2011, were \$468.4 million and \$705.1 million, respectively, and these contracts had a fair value of \$(4.0) million and \$7.0 million, respectively. For the three and six months ended June 30, 2012, we recorded net realized and unrealized gains of \$11.5 million and \$4.9 million, respectively, on foreign currency forward contracts and for the three and six months ended June 30, 2011, we recorded net realized and unrealized losses of \$4.0 million and \$40.0 million, respectively, on foreign currency forward contracts.

## 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, FSML subsidiaries and Flagstone Suisse, each of whose functional currency 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 the time claims are paid.

With respect to loss reserves denominated in non-U.S. dollar currencies, our policy is to hedge the majority of our non-U.S. dollar foreign currency exposure with derivative instruments such as currency swaps and foreign currency forward contracts.

#### Investments

A significant portion of the securities held in our investment portfolios are measured in U.S. dollars. Within our fixed maturity portfolio, a portion is invested in non-U.S. dollar currencies, which are hedged to U.S. dollars. 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 investment funds which may or may not be hedged.

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Financing

Certain subsidiaries of ours have a functional currency other than the U.S. dollar. Our practice is to hedge the net investment in those subsidiaries and designate foreign currency forward contracts as hedging instruments. The contractual amount of these contracts as at June 30, 2012 and December 31, 2011 was \$51.9 million and \$51.6 million, respectively, and the contracts had a fair value of \$(1.1) million and \$(0.5) million, respectively. During the three and six months ended June 30, 2012 and 2011, we recorded net realized and unrealized gains of \$3.1 million and \$1.0 million, respectively, and net realized and unrealized losses of \$0.8 million and \$2.0 million, respectively, directly into comprehensive income as part of the cumulative translation adjustment for the effective portion of the hedge.

We 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, we exchanged €13.0 million for \$17.8 million, and will receive Euribor plus 354 basis points and pay LIBOR plus 419 basis points. The swap expires on September 15, 2013 and had a fair value of \$(1.5) million as at June 30, 2012.

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 six months ended June 30, 2012 and 2011, approximately 41.3% and 39.1%, respectively, was written in currencies other than the U.S. dollar. For the six months ended June 30, 2012, we had net foreign exchange losses of \$0.9 million compared to \$37.0 million for the same period in 2011.

We do not hedge currencies for which our asset or liability exposures are not material or where we are unable or it is impractical to do so. In such cases, we are exposed to foreign currency risk. However, we do 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 consolidated results of operations, except insofar as (a) inflation may affect interest rates, and (b) losses and loss expenses may be affected by inflation.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report, including the documents we incorporate by reference, 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 of similar 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: the ongoing impact on our business of our net loss in 2011 and our inability to continue our return to profitability in a timely manner, if at all; the failure to consummate the divestiture of our former Lloyd’s reportable segment described above in the “Recent Developments” section of Part I, Item 2 of this Quarterly Report, and the timing of the Lloyd’s divestiture; the amount of costs, fees, expenses, indemnification obligations, purchase price adjustments and charges related to the divestitures and realignment initiatives described in this Quarterly Report on acceptable terms; the possibility that the benefits anticipated from the divestitures and realignment initiatives described in this Quarterly Report will not be fully realized, or the timing thereof; the failure to successfully implement the Company’s business strategy despite the completion of the divestitures and realignment initiatives described in this Quarterly Report; cancellation of our reinsurance contracts by cedents, market conditions affecting our common share price; the possibility that pricing changes in our industry may make it difficult or impossible for us to effectively compete or produce attractive returns; 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 and the premium environment; 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 impact of our financial strength ratings and the consequences to our business of our sustained negative outlook or any downgrade; our ability to raise capital on favorable terms, or at all; the estimates reported by cedents and brokers on pro-rata contracts and certain excess of loss contracts in which the deposit premium is not specified; the inherent uncertainties of establishing reserves for loss and loss adjustment expenses, and 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; our exposure to many different counterparties in the financial service industry, and the related credit risk of counterparty default; changes in general economic conditions; changes in governmental regulation or tax laws in the jurisdictions where we conduct business; our need for financial flexibility to maintain our current level of 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 and premium dynamics in our markets relating to growing capital levels in the insurance and reinsurance industries; the investment environment, declining demand due to increased retentions by cedents and other factors; our ability to continue to implement our expense reduction initiatives; the impact of Eurozone instability and terrorist activities on the economy; and rating agency policies and practices particularly related to the duration a company may remain on negative outlook without further rating action.

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 are subject to significant uncertainties and 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, the 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 second fiscal quarter of 2012 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.

Item 1B. Unresolved Staff Comments

NONE

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

NONE

Item 3. Defaults upon Senior Securities

NONE

Item 4. Mine Safety Disclosure

Not applicable.

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.

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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: August 7, 2012

FLAGSTONE REINSURANCE HOLDINGS, S.A.

By: /s/ David A. Brown  
Name: David A. Brown  
Title: Chief Executive Officer  
(Authorized Officer)

By: /s/ Patrick Boisvert  
Name: Patrick Boisvert  
Title: Chief Financial Officer  
(Principal Financial Officer)

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EXHIBIT INDEX  
Pursuant to Item 601 of Regulation S-K

Exhibit No.	Description of Exhibit
10.1	Share Purchase Agreement, dated as of April 3, 2012, between Flagstone (Gibraltar) Limited and ANV Risk BV.
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 June 30, 2012.
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 June 30, 2012.
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 June 30, 2012.
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 June 30, 2012.
*101	The following materials from the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Operations and Comprehensive Income; (iii) the Consolidated Statements of Shareholders' Equity; (iv) the Consolidated Statements of Cash Flows; and (v) the Notes to Condensed Consolidated Financial Statements, tagged as a block of text and in detail.

\* As provided in Rule 406T of Regulation S-T, this information is "furnished" herewith and not "filed" for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934. Such exhibit will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934 unless the Company specifically incorporates it by reference.