Flagstone Reinsurance Holdings Ltd
Form 10-Q
August 05, 2008

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

Form 10-Q

þ Quarterly Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2008

OR

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

Commission file number 001-33364

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

Bermuda	98-0481623
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

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

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

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

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

New York Stock Exchange
Bermuda Stock Exchange

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer 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 o	Accelerated filer o
Non-accelerated filer þ (Do not check if a smaller reporting company)	Smaller reporting company o

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

As of August 5, 2008 the Registrant had 85,346,325 common voting shares outstanding, with a par value of $0.01 per share.

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PART I - FINANCIAL INFORMATION
Item 1. Financial Statements
FLAGSTONE REINSURANCE HOLDINGS LIMITED
CONDENSED CONSOLIDATED BALANCE SHEETS
(Expressed in thousands of U.S. dollars, except share data)

	As at June 30, 2008 (Unaudited)	As at December 31, 2007
ASSETS		
Investments:		
Fixed maturities, at fair value (Amortized cost: 2008 - $803,528; 2007 - $1,099,149)	$ 804,798	$ 1,109,105
Short term investments, at fair value (Amortized cost: 2008 - $20,267; 2007 - $23,660)	20,196	23,616
Equity investments, at fair value (Cost: 2008 - $117,556; 2007 - $73,603)	107,935	74,357
Other investments	464,141	293,166
Total Investments	1,397,070	1,500,244
Cash and cash equivalents	562,816	362,680
Premium balances receivable	314,456	136,555
Unearned premiums ceded	39,682	14,608
Accrued interest receivable	7,214	9,915
Receivable for investments sold	2,942	–
Deferred acquisition costs	51,467	30,607
Funds withheld	10,096	6,666
Goodwill	13,171	10,781
Intangible assets	775	775
Other assets	73,423	30,942
Due from related parties	64	–
Total Assets	$ 2,473,176	$ 2,103,773
LIABILITIES		
Loss and loss adjustment expense reserves	$ 233,596	$ 180,978
Unearned premiums	389,223	175,607
Insurance and reinsurance balances payable	33,749	12,088
Payable for investments purchased	6,162	41,750
Long term debt	255,037	264,889
Other liabilities	79,302	33,198
Total Liabilities	997,069	708,510
Minority Interest	195,923	184,778
SHAREHOLDERS' EQUITY		
Common voting shares, 150,000,000 authorized, $0.01 par value, issued and outstanding (2008 - 85,346,325; 2007 - 85,309,107)	853	853
Additional paid-in capital	911,964	905,316
Accumulated other comprehensive income	2,718	7,426
Retained earnings	364,649	296,890

Total Shareholders' Equity		1,280,184		1,210,485
Total Liabilities, Minority Interest and Shareholders' Equity	$	2,473,176	$	2,103,773

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

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

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
REVENUES				
Gross premiums written	$ 271,178	$ 181,345	$ 513,424	$ 388,358
Premiums ceded	(38,435)	–	(54,449)	(8,245)
Net premiums written	232,743	181,345	458,975	380,113
Change in net unearned premiums	(90,976)	(69,503)	(181,951)	(167,045)
Net premiums earned	141,767	111,842	277,024	213,068
Net investment income	13,279	20,531	31,975	34,162
Net realized and unrealized (losses) gains - investments	(9,339)	(3,741)	(21,751)	767
Net realized and unrealized gains (losses) - other	11,132	1,840	(1,105)	1,846
Other income	2,127	251	3,851	924
Total revenues	158,966	130,723	289,994	250,767
EXPENSES				
Loss and loss adjustment expenses	56,298	77,257	96,065	125,005
Acquisition costs	27,210	14,725	51,375	27,443
General and administrative expenses	24,214	13,800	50,763	28,469
Interest expense	4,609	3,520	9,949	6,784
Net foreign exchange losses (gains)	1,630	(56)	(5,069)	(1,338)
Total expenses	113,961	109,246	203,083	186,363
Income before income taxes, minority interest and interest in earnings of equity investments	45,005	21,477	86,911	64,404
Provision for income tax	(442)	(77)	(1,307)	(122)
Minority interest	(2,615)	(7,892)	(10,796)	(15,625)
Interest in earnings of equity investments	–	1,186	–	1,647
NET INCOME	$ 41,948	$ 14,694	$ 74,808	$ 50,304
Change in currency translation adjustment	(2,766)	(1,741)	(4,186)	(2,017)
COMPREHENSIVE INCOME	$ 39,182	$ 12,953	$ 70,622	$ 48,287
Weighted average common shares outstanding—Basic	85,470,205	85,139,757	85,470,043	78,479,958
Weighted average common shares outstanding—Diluted	85,638,506	85,198,147	85,714,196	78,529,631
Net income per common share outstanding—Basic	$ 0.49	$ 0.17	$ 0.88	$ 0.64
Net income per common share outstanding—Diluted	$ 0.49	$ 0.17	$ 0.87	$ 0.64

Dividends declared per common share	$ 0.04	$ –	$ 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 LIMITED
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Expressed in thousands of U.S. dollars, except share data)

	For the Six Months Ended	
	June 30, 2008	June 30, 2007
Common voting shares:		
Balance at beginning of period	85,309,107	71,547,891
Issued during the period, net	37,218	13,750,000
Balance at end of period	85,346,325	85,297,891
Share capital:		
Common voting shares		
Balance at beginning of period	$ 853	$ 715
Issued during period, net	–	138
Balance at end of period	853	853
Additional paid-in capital		
Balance at beginning of period	905,316	728,378
Issue of shares, net	(364)	185,488
Issuance costs (related party: 2008 - $nil ; 2007 - $3,430)	–	(16,839)
Share based compensation expense	7,012	4,252
Balance at end of period	911,964	901,279
Accumulated other comprehensive income (loss)		
Balance at beginning of period	7,426	(4,528)
Change in currency translation adjustment	(4,186)	(2,017)
Defined benefit plan - transitional obligation	(522)	–
Cumulative effect adjustment from adoption of new accounting principle SFAS 159	–	4,009
Balance at end of period	2,718	(2,536)
Retained earnings		
Balance at beginning of period	296,890	139,954
Cumulative effect adjustment from adoption of accounting principle	–	(4,009)
Dividend declared	(7,049)	–
Net income for the period	74,808	50,304
Balance at end of period	364,649	186,249
Total Shareholders' Equity	$ 1,280,184	$ 1,085,845

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

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

	For the Six Months Ended June 30, 2008	June 30, 2007
Cash flows provided by (used in) operating activities:		
Net income	$ 74,808	$ 50,304
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized and unrealized losses (gains)	22,856	(2,613)
Minority interest	10,796	15,625
Depreciation expense	2,214	820
Share based compensation expense	6,788	4,252
Interest in earnings of equity investments	–	(1,647)
Accretion/amortization on fixed maturities	(9,736)	(5,975)
Changes in assets and liabilities, excluding net assets acquired:		
Reinsurance premium receivable	(175,080)	(151,289)
Unearned premiums ceded	(24,728)	(3,323)
Deferred acquisition costs	(20,439)	(21,977)
Funds withheld	(3,386)	(5,138)
Loss and loss adjustment expense reserves	47,063	112,627
Unearned premiums	210,635	170,361
Insurance and reinsurance balances payable	21,478	883
Other changes in assets and liabilities, net	4,785	3,984
Net cash provided by operating activities	168,054	166,894
Cash flows provided by (used in) investing activities:		
Net cash received in acquisitions of subsidiaries	4,729	4,581
Purchases of fixed income securities	(936,439)	(838,231)
Sales and maturities of fixed income securities	1,230,546	574,260
Purchases of equity securities	(39,974)	(25,171)
Purchases of other investments	(330,203)	(69,405)
Sales of other investments	144,675	–
Purchases of fixed assets	(10,786)	(3,666)
Net cash provided by (used in) investing activities	62,548	(357,632)
Cash flows (used in) provided by financing activities:		
Issue of common shares, net of issuance costs paid	(364)	171,644
Issue of notes, net of issuance costs paid	–	98,940
Contribution of minority interest	(429)	83,100
Repurchase of minority interest	(8,652)	–
Dividend paid on common shares	(6,825)	–
Repayment of long term debt	(9,195)	–
Other	(4,003)	(763)
Net cash (used in) provided by financing activities	(29,468)	352,921

Effect of foreign exchange rate on cash and cash equivalents		(998)		(1,490)
Increase in cash and cash equivalents		200,136		160,693
Cash and cash equivalents - beginning of period		362,680		261,352
Cash and cash equivalents - end of period	$	562,816	$	422,045
Supplemental cash flow information:				
Receivable for investments sold	$	2,942	$	–
Payable for investments purchased	$	6,162	$	1,201
Interest paid	$	10,679	$	6,416

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

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

1. Basis of Presentation and Consolidation

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

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

In the opinion of management, these unaudited condensed consolidated financial statements reflect all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the Company’s financial position and results of operations as at the end of and for the periods presented. The results of operations and cash flows for any interim period will not necessarily be indicative of the results of operations and cash flows for the full fiscal year or subsequent quarters. This Quarterly Report on Form 10-Q should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2007 filed with the Securities and Exchange Commission (the “SEC”) on March 19, 2008.

Certain prior year balances were reclassified to conform with the current year classifications.

2. New Accounting Pronouncements

The Company maintains a contributory defined benefit plan that covers certain employees at Flagstone Suisse. The Company accounts for this pension plan using the accrual method, consistent with the requirements of FASB Statement No. 158, “Employers’ Accounting for Defined Benefit Pension and Other Post-retirement Plans, an amendment of FASB Statement No. 87, 88, 106 and 132” (“SFAS 158”), which was adopted by the Company on January 1, 2008. SFAS 158 requires an employer to recognize the over-funded or under-funded status of a defined benefit postretirement plan as an asset or liability in its balance sheet and to recognize changes in funded status through comprehensive income in the year in which the changes occur. An unfunded transitional liability of $0.6 million was recorded in accumulated other comprehensive income at January 1, 2008 and is being amortized over the estimated average remaining service life of 12.2 years. The net periodic pension expense for 2008 is expected to be approximately $1.2 million, of which $0.3 million and $0.6 million has been recorded as a pension expense in the three and six months ended June 30, 2008, respectively. A pension asset of $0.8 million and a pension liability of $1.1 million were recognized in the June 30, 2008 unaudited condensed consolidated balance sheet. The Company funds the plan at the amount required by local legal requirements.

In March 2008, the FASB released Statement No. 161, "Disclosures About Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133" ("SFAS 161"), which expands the disclosure requirements in SFAS 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133") about an entity's derivative instruments and hedging activities. SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and disclosures about credit-risk related contingent features in derivative agreements. This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early adoption encouraged. The adoption of SFAS 161 will not affect consolidated financial condition and results of operations, and the Company is currently assessing the impact of this statement on its disclosure requirements.

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

In May 2008, the FASB issued Statement No. 162, "The Hierarchy of Generally Accepted Accounting Principles" ("SFAS 162") which identifies the sources of generally accepted accounting principles and provides a framework, or hierarchy, for selecting the principles to be used in preparing U.S. GAAP financial statements for nongovernmental entities. This Statement makes the GAAP hierarchy explicitly and directly applicable to preparers of financial statements, a step that recognizes preparers' responsibilities for selecting the accounting principles for their financial statements. The hierarchy of authoritative accounting guidance is not expected to change current practice but is expected to facilitate the FASB's plan to designate as authoritative its forthcoming codification of accounting standards. This Statement is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board's ("PCAOB") related amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles", to remove the GAAP hierarchy from its auditing standards.

In May 2008, the FASB also issued Statement No. 163, "Accounting for Financial Guarantee Insurance Contracts – an Interpretation of FASB Statement No. 60" ("SFAS 163") which prescribes the accounting for premium revenue and claims liabilities by insurers of financial obligations, and requires expanded disclosures about financial guarantee insurance contracts. SFAS 163 applies to financial guarantee insurance and reinsurance contracts issued by insurers subject to Statement No. 60 "Accounting and Reporting by Insurance Enterprises" ("SFAS 60"). The Statement does not apply to insurance contracts that are similar to financial guarantee insurance contracts such as mortgage guaranty or trade-receivable insurance, financial guarantee contracts issued by noninsurance entities, or financial guarantee contracts that are derivative instruments within the scope of SFAS 133. SFAS 163 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years, except for certain disclosure requirements about the risk-management activities of the insurance enterprise that are effective for the first quarter beginning after the Statement was issued. Except for those disclosures, early application is prohibited. SFAS 163 is not expected to have an effect on the Company as we do not enter into financial guarantee contracts.

3. Business Combinations

Imperial Reinsurance Company Limited

On June 26, 2008, Flagstone Suisse purchased 3,714,286 shares (representing a 65% interest) in Imperial Reinsurance Company Limited ("Imperial Re") for a purchase price of $18.6 million. The Company recorded $1.1 million of goodwill on the acquisition. The Company is in the process of determining the valuation of certain intangible assets. The allocation of the purchase price is therefore subject to change to account for the outcome of the valuation of these intangible assets. In July, 2008, the South Africa Registrar of Companies recorded a change of name from Imperial Re to Flagstone Reinsurance Africa Limited ("Flagstone Africa").

Flagstone provides technical underwriting, modeling, and actuarial support to Flagstone Africa's underwriting operations pursuant to the Technical Underwriting Agreement between Flagstone and Flagstone Africa dated October 2007. There have been no changes to the Technical Underwriting Agreement. In addition, Flagstone also has a Quota Share arrangement with Flagstone Africa.

Flagstone Africa is domiciled in South Africa and writes multiple lines of reinsurance in sub-Saharan Africa. This acquisition dovetails with the Company's strategy, giving Flagstone capacity in a fast growing and technically adequate market. The Company believes that its capital and technical support will enhance Flagstone Africa's services, increase market penetration and broaden product distribution, both by line of business and geographically within Africa.

Island Heritage

On June 30, 2008, the Company acquired an additional 16,919 shares in Island Heritage (representing 5% of its common shares) for total consideration of $3.3 million. The Company recorded $1.3 million of goodwill on the acquisition.

4. Investments

Fair value disclosure

The valuation technique used to fair value the financial instruments is the market approach which uses prices and other relevant information generated by market transactions involving identical or comparable assets. In accordance with SFAS No. 157, "Fair Value Measurements" ("SFAS 157"), the Company determined that its investments in U.S. government securities, equity securities and fixed income fund are stated at Level 1 fair value. Investments in corporate bonds, mortgage-backed securities, hedge funds, and asset backed securities, real estate investment trust ("REITs") and REIT funds are stated at Level 2, whereas the Company's investment in Alliance International Reinsurance Public Company Limited ("Alliance Re" – see Note 11) and the investment funds that are private placement investments and catastrophe bonds are stated at Level 3 fair value. During the quarter ended June 30, 2008, the Company purchased a 14.6% interest in Alliance Re. The investment in Alliance Re has been recorded at fair value based on the recently completed arms length purchase negotiated between the Company and external third parties.

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

As at June 30, 2008 and December 31, 2007, the Company's investments are allocated between levels as follows:

	Fair Value Measurement at June 30, 2008, using:			
	Fair Value Measurements	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Description				
Fixed maturity investments	$ 804,798	$ 409,958	$ 394,840	$ –
Short term investments	20,196	20,196	–	–
Equity investments	107,935	107,935	–	–
	932,929	538,089	394,840	–
Other Investments				
Alliance Re	6,846	–	–	6,846
Real estate investment trust funds	69,679	–	69,679	–
Investment funds	31,268	–	19,404	11,864
Catastrophe bonds	40,081	–	–	40,081
Fixed income fund	316,267	316,267	–	–
	464,141	316,267	89,083	58,791
Totals	$ 1,397,070	$ 854,356	$ 483,923	$ 58,791

	Fair Value Measurement at December 31, 2007, using:			
	Fair Value Measurements	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Description				
Fixed maturity investments	$ 1,109,105	$ 471,811	$ 637,294	$ –
Short term investments	23,616	4,914	18,702	–
Equity investments	74,357	74,357	–	–

	1,207,078	551,082	655,996	–
Other Investments				
Real estate investment trusts	12,204	–	12,204	–
Investment funds	31,249	–	20,041	11,208
Catastrophe bonds	36,619	–	–	36,619
Fixed income fund	212,982	212,982	–	–
	293,054	212,982	32,245	47,827
Totals	$ 1,500,132	$ 764,064	$ 688,241	$ 47,827

For reconciliation purposes, the table above does not include an equity investment of $112,000 in which the Company is deemed to have a significant influence and as such, is not accounted for at fair value under SFAS 159.

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

The reconciliation of the fair value for the Level 3 investments as at June 30, 2008, including net purchases and sales, realized gains and change in unrealized gains, is set out below:

Description	Investment funds	Catastrophe bonds	Alliance Re
Fair value, December 31, 2007	$ 11,208	$ 36,619	$ –
Total unrealized gains included in earnings	1,006	33	–
Fair value, March 31, 2008	$ 12,214	$ 36,652	$ –
Total unrealized gains included in earnings	(856)	(71)	–
Net purchases and sales	506	3,500	6,846
Closing fair value, June 30, 2008	$ 11,864	$ 40,081	$ 6,846

5. Derivatives

The Company writes certain reinsurance contracts that are classified as derivatives under SFAS 133. In addition, the Company enters into derivative instruments such as interest rate futures contracts, interest rate swaps, foreign currency forward contracts and foreign 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 and total return swaps to gain or reduce its exposure to the underlying asset or index. The Company also purchases “to be announced” mortgage-backed securities (“TBAs”) as part of its investing activities and futures options on weather indexes as part of its reinsurance activities. The Company manages the exposure to these instruments based on guidelines established by management and approved by the Board of Directors.

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

Interest rate swaps

The Company uses interest rate swap contracts in the portfolio as protection against unexpected shifts in interest rates, which would affect the fair value of the fixed maturity portfolio. By using interest rate swaps, the overall duration or interest rate sensitivity of the portfolio can be altered. The Company also uses interest rate swaps to manage its borrowing costs on its long term debt. As of June 30, 2008 and December 31, 2007, there were a total of $nil and $389.9 million of interest rate swaps in the portfolio with a total fair value of $nil and $2.3 million, respectively. During the three months ended June 30, 2008 and 2007, the Company recorded realized and unrealized gains on interest rate swaps of $8.0 million and realized and unrealized losses of $0.2 million respectively, and for the six months ended June 30, 2008 and 2007, the Company recorded realized and unrealized gains of $0.3 million and realized and unrealized losses of $0.2 million on interest rate swaps.

The interest rate swap agreements entered into between the Company and Lehman Brothers Special Financing Inc. on December 7, 2007, as well as the agreement entered into between the Company and Citibank N.A. on December 7, 2007, were unwound during the second quarter of 2008.

Foreign currency swaps

The Company periodically uses foreign currency swaps to minimize the effect of fluctuating foreign currencies. In September 2006, the Company entered into a foreign currency swap, in relation to the Euro-denominated Deferrable Interest Debentures (“Deferrable Interest Debentures”). Under the terms of the foreign currency swap, the Company exchanged €13.0 million for $16.7 million, will receive Euro Interbank Offered Rate (“Euribor”) plus 354 basis points and will pay London Interbank Offering Rate (“LIBOR”) plus 371 basis points. The swap expires on September 15, 2011 and had a fair value of $4.2 million and $2.5 million as at June 30, 2008 and December 31, 2007, respectively. During the three months ended June 30, 2008 and 2007, the Company recorded realized and unrealized gains of $0.1 million and $0.3 million, respectively. During the six months ended June 30, 2008 and 2007, the Company recorded realized and unrealized gains of $1.9 million and $0.5 million, respectively, on foreign currency swaps.

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

Foreign currency forwards

The Company and its subsidiaries use foreign currency forward contracts to manage currency exposure. The contractual amount of these contracts as at June 30, 2008 and December 31, 2007 was $481.5 million and $311.1 million, respectively, and these contracts had a fair value of $(8.3) million and $(7.1) million, respectively. The Company has designated $427.2 million and $264.4 million of foreign currency forwards contractual value as hedge instruments, which had a fair value of $(7.8) million and $(3.4) million as at June 30, 2008 and December 31, 2007, respectively. During the three months ended June 30, 2008 and 2007, the Company recorded $2.6 million and $1.3 million, respectively, of realized and unrealized gains on foreign currency forward contracts and for the six months ended June 30, 2008 and 2007, the Company recorded $3.0 million of realized and unrealized losses and $0.9 million of realized and unrealized gains, respectively, on foreign currency forward contracts. During the three and six months ended June 30, 2008, the Company recorded $4.3 million of realized and unrealized gains and $25.6 million of realized and unrealized losses, respectively, directly into comprehensive income as part of the cumulative translation adjustment for the effective portion of the hedge.

Total return swaps

The Company uses total return swaps to gain exposure to the U.S. real estate market. The total return swaps allow the Company to earn the return of the underlying index while paying floating interest plus a spread to the counterparty. As of June 30, 2008, there were total return swaps with a notional amount of $84.7 million and a fair value of $(4.3) million in the portfolio and as of December 31, 2007, the notional amount of the total return swaps was $14.2 million and they had a fair value of $(4.9) million. During the three months ended June 30, 2008 and 2007, the Company recorded $4.5 million and $1.7 million of realized and unrealized losses, respectively, on total return swaps and for the six months ended June 30, 2008 and 2007, the Company recorded $4.8 million and $2.8 million of realized and unrealized losses, respectively, on total return swaps.

To be announced mortgage backed securities

By acquiring a TBA, the Company makes a commitment to purchase a future issuance of mortgage-backed securities. For the period between purchase of the TBA and issuance of the underlying security, the Company's position is accounted for as a derivative in the consolidated financial statements. At June 30, 2008 and December 31, 2007, the notional principal amount of TBAs was $69.8 million and $18.2 million and the fair value was $0.2 million and $0.2 million, respectively. During the three months ended June 30, 2008 and 2007, the Company recorded $0.7 million and $0.7 million, respectively, of realized and unrealized losses and for the six months ended June 30, 2008 and 2007, the Company recorded $0.3 million and $0.6 million, respectively, of realized and unrealized losses on TBAs.

Futures

The Company has entered into equity index, bond index and interest rate futures. At June 30, 2008 and December 31, 2007, the notional amount of these futures was $404.1 million and $421.0 million, respectively. The net fair value of futures contracts was $(10.9) million and $(2.2) million as at June 30, 2008 and December 31, 2007, respectively. During the three months ended June 30, 2008 and 2007, the Company recorded $19.1 million and $9.6 million, respectively, of realized and unrealized gains on futures and for the six months ended June 30, 2008 and 2007, the Company recorded $0.9 million of realized and unrealized losses and $9.7 million of realized and unrealized gains, respectively, on futures.

Other reinsurance derivatives

The Company has entered into industry loss warranty ("ILW") transactions that may be structured as reinsurance or derivatives. For those transactions determined to be derivatives, the fair value was $(0.1) million and $(1.3) million at June 30, 2008 and December 31, 2007, respectively. During the three months ended June 30, 2008 and 2007, the Company recorded $0.5 million and $0.3 million, respectively, of realized and unrealized gains on ILWs determined to be derivatives and for the six months ended June 30, 2008 and 2007, the Company recorded $1.2 million and $0.4 million, respectively, of realized and unrealized gains on ILWs determined to be derivatives.

Beginning in 2008, the Company entered into futures options contracts, both purchased and written, on major hurricane indexes that are traded on the Chicago Mercantile Exchange. As at June 30, 2008, the notional net exposure under those weather derivatives was $4.5 million. The net notional exposure is determined based on the futures exchange futures specifications. The net fair value of the options were recorded on the balance sheet, with purchased options of $2.2 million recorded in other assets and written options of $3.2 million recorded in other liabilities. The unrealized gains and losses recorded on the hurricane indexes were $nil during the three months and six months ended June 30, 2008.

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Fair value disclosure

In accordance with SFAS 157, the fair value of derivative instruments held as of June 30, 2008 and December 31, 2007 is allocated between levels as follows:

	Fair Value Measurement at June 30, 2008, using:			
	Fair Value Measurements	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Derivatives				
Futures contracts	$ (10,914)	$ (10,914)	$ –	$ –
Swaps	(56)	–	(56)	–
Forward currency contracts	(8,334)	–	(8,334)	–
Mortgage backed securities TBA	213	–	213	–
Other reinsurance derivatives	(1,165)	–	(1,038)	(127)
Total derivatives	$ (20,256)	$ (10,914)	$ (9,215)	$ (127)

	Fair Value Measurement at December 31, 2007, using:			
	Fair Value Measurements	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Derivatives				
Futures contracts	$ (2,228)	$ (2,228)	$ –	$ –
Swaps	(153)	–	(153)	–
Forward currency contracts	(7,067)	–	(7,067)	–
Mortgage backed securities TBA	173	–	173	–
Other reinsurance derivatives	(1,305)	–	–	(1,305)
Total derivatives	$ (10,580)	$ (2,228)	$ (7,047)	$ (1,305)

Derivatives are recorded on the balance sheet as other assets or other liabilities.

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

Other reinsurance derivatives		
Opening fair value, December 31, 2007	$	(1,305)
Total unrealized gains included in earnings		714
Closing fair value, March 31, 2008		(591)
Total unrealized gains included in earnings		464
Closing fair value, June 30, 2008	$	(127)

6. Debt and Financing Arrangements

Long term debt

During the quarter ended June 30, 2008, the Company repurchased, in a privately negotiated transaction, $11.25 million of principal amount of its outstanding $100.0 million Floating Rate Deferrable Interest Junior Subordinated Notes (the "Notes"). The purchase price paid for the Notes was 81% of face value, representing a discount of 19%. The repurchase resulted in a gain of $2.0 million, net of unamortized debt issuance costs of $0.1 million that were written off. As a result, the gain has been included as a gain on early extinguishment of debt under "Other income" in the accompanying Condensed Consolidated Statements of Operations and Comprehensive Income for the three and six months ended June 30, 2008.

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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 they may be called by the Company. For the three months ended June 30, 2008 and 2007, the Company incurred interest expense of $4.6 million and $3.5 million, respectively, and for the six months ended June 30, 2008 and 2007, the Company incurred interest expense of $9.9 million, and $6.8 million, respectively, on the Deferrable Interest Debentures. Also, at June 30, 2008 and December 31, 2007, the Company had $1.4 million and $1.9 million, respectively, of interest payable included in other liabilities in the unaudited condensed consolidated balance sheets.

Letter of credit facility

In August 2006, the Company entered into a $200.0 million uncommitted letter of credit facility agreement with Citibank N.A. In April 2007, the Company increased its uncommitted letter of credit facility agreement with Citibank N.A. from $200.0 million to $400.0 million. As at June 30, 2008 and December 31, 2007, $72.1 million and $73.8 million, respectively, had been drawn under this facility, and the drawn amount of the facility was secured by $80.1 million and $82.0 million, respectively, of fixed maturity securities from the Company’s investment portfolio.

In September 2007, the Company entered into a $200.0 million uncommitted letter of credit facility agreement with Wachovia Bank, N.A. Although the Company has not drawn upon this facility as at June 30, 2008, if drawn upon, the utilized portion of the facility will be secured by an appropriate portion of securities from the Company’s investment portfolio.

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

7. Share Based Compensation

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

Performance Share Units

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

A summary of the activity under the PSU Plan as at June 30, 2008 and changes during the three months and six months ended June 30, 2008 is as follows:

Three Months Ended June 30, 2008	Six Months Ended June 30, 2008
Number	Number

		Weighted average grant date fair value	Weighted average remaining contractual term		Weighted average grant date fair value	Weighted average remaining contractual term
Outstanding at beginning of period	2,308,658	$ 12.63	1.8	1,658,700	$ 12.07	1.7
Granted	4,000	12.00		731,958	13.89	
Forfeited	–	0.00		(78,000)	12.54	
Outstanding at end of period	2,312,658	12.63	1.5	2,312,658	12.63	1.5

As at June 30, 2008 and December 31, 2007, there was a total of $17.9 million and $11.9 million, respectively, of unrecognized compensation cost related to non-vested PSUs; that cost is expected to be recognized over a period of approximately 2.0 and 2.1 years, respectively. Compensation expense of $2.5 million and $1.5 million has been recorded in general and administrative expenses for the three months ended June 30, 2008 and 2007, respectively, and $4.8 million and $2.8 million has been recorded in general and administrative expenses for the six months ended June 30, 2008 and 2007, respectively, in relation to the PSU Plan.

No PSUs have vested or been cancelled since the inception of the PSU Plan.

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Restricted Share Units

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

A summary of the activity under the RSU Plan as at June 30, 2008 and changes during the three months and six months ended June 30, 2008 are as follows:

	Three Months Ended June 30, 2008			Six Months Ended June 30, 2008		
	Number	Weighted average grant date fair value	Weighted average remaining contractual term	Number	Weighted average grant date fair value	Weighted average remaining contractual term
Outstanding at beginning of period	532,558	$ 13.04	0.8	326,610	$ 12.45	0.6
Granted	8,600	12.15		239,315	13.82	
Forfeited	(3,950)	13.35		(20,900)	13.67	
Vested in the period	(59,700)	10.72		(67,517)	10.81	
Outstanding at end of period	477,508	13.32	0.7	477,508	13.32	0.7

As at June 30, 2008 and December 31, 2007, there was a total of $2.3 million and $1.3 million, respectively, of unrecognized compensation cost related to non-vested RSUs; that cost is expected to be recognized over a period of approximately 1.2 and 0.9 years, respectively. A compensation expense of $0.7 million and $1.1 million has been recorded in general and administrative expenses for the three months ended June 30, 2008 and 2007, respectively, and $2.0 million and $1.4 million has been recorded in general and administrative expenses for the six months ended June 30, 2008 and 2007, respectively, in relation to the RSU Plan.

During the quarter ended June 30, 2008, 59,700 RSUs granted to employees vested. No other RSUs granted to employees since the inception of the RSU Plan in July 2006 have vested and no RSUs granted to employees have been cancelled since the inception of the RSU Plan. During the three months ended June 30, 2008 and 2007, respectively, nil and 61,761 RSUs and for the six months ended June 30, 2008 and 2007, respectively, 55,715 and 61,761 RSUs were granted to the directors.

8. Earnings Per Common Share

The computation of basic and diluted earnings per common share for the three and six months ended June 30, 2008 and 2007 is as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
Basic earnings per common share				
Net income	$ 41,948	$ 14,694	$ 74,808	$ 50,304
Weighted average common shares outstanding	85,317,247	85,050,638	85,314,637	78,408,388
Weighted average vested restricted share units	152,958	89,119	155,406	71,570
Weighted average common shares outstanding—Basic	85,470,205	85,139,757	85,470,043	78,479,958
Basic earnings per common share	$ 0.49	$ 0.17	$ 0.88	0.64
Diluted earnings per common share				
Net income	$ 41,948	$ 14,694	$ 74,808	$ 50,304
Weighted average common shares outstanding	85,317,247	85,050,638	85,314,637	78,408,388
Weighted average vested restricted share units outstanding	152,958	89,119	155,406	71,570
	85,470,205	85,139,757	85,470,043	78,479,958
Share equivalents:				
Weighted average unvested restricted share units	168,301	58,390	244,153	49,673
Weighted average common shares outstanding—Diluted	85,638,506	85,198,147	85,714,196	78,529,631
Diluted earnings per common share	$ 0.49	$ 0.17	$ 0.87	$ 0.64

As at June 30, 2008 and 2007, there was a warrant outstanding which would result in the issuance of 8,585,747 common shares that were excluded from the computation of diluted earnings per common share because the effect would be anti-dilutive. Because the number of shares contingently issuable under the PSU Plan depends on the average DROE over a three year period, the PSUs are excluded from the calculation of diluted earnings per common share until the end of the performance period, at which time the number of shares issuable under the PSU Plan will be known. As at June 30, 2008 and 2007, there were 2,312,658 and 1,538,000 PSUs outstanding, respectively. The maximum number of common shares that could be issued under the PSU Plan at June 30, 2008 and 2007 was 4,625,316 and 3,076,000, respectively.

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9. Legal Proceedings

In the normal course of business, the Company may become involved in various claims litigation and legal proceedings. As at June 30, 2008, the Company was not a party to any litigation or arbitration proceedings.

10. Segment Reporting

The Company holds a controlling interest in Island Heritage Holdings Company (“Island Heritage”), whose primary business is insurance. As a result of the strategic significance of the insurance business to the Company, and given the relative size of revenues generated by the insurance business, the Company revised its segment structure, effective January 1, 2008, to better align the Company’s operating and reporting structure with its current strategy. The Company determined that the allocation of resources and the assessment of performance should be reviewed separately for both segments. The Company is currently organized into two business segments: Reinsurance and Insurance. The Company regularly reviews its financial results and assesses performance on the basis of these two operating segments.

Those segments are more fully described as follows:

Reinsurance

Our Reinsurance segment has three main units:

1) Property Catastrophe Reinsurance. Property catastrophe reinsurance contracts are typically “all risk” in nature, meaning that they protect against losses from earthquakes and hurricanes, as well as other natural and man-made catastrophes such as tornados, wind, fires, winter storms, and floods (where the contract specifically provides for coverage). Losses on these contracts typically stem from direct property damage and business interruption. To date, property catastrophe reinsurance has been our most important product. We write property catastrophe reinsurance primarily on an excess of loss basis. In the event of a loss, most contracts of this type require us to cover a subsequent event and generally provide for a premium to reinstate the coverage under the contract, which is referred to as a “reinstatement premium”. These contracts typically cover only specific regions or geographical areas, but may be on a worldwide basis.

2) Property Reinsurance. We also provide reinsurance on a pro rata share basis and per risk excess of loss basis. Per risk reinsurance protects insurance companies on their primary insurance risks on a single risk basis, for example, covering a single large building. All property per risk and pro rata business is written with loss limitation provisions, such as per occurrence or per event caps, which serve to limit exposure to catastrophic events.

3) Short-tail Specialty and Casualty Reinsurance. We also provide short-tail specialty and casualty reinsurance for risks such as aviation, energy, accident and health, satellite, marine and workers’ compensation catastrophe. Most short-tail specialty and casualty reinsurance is written with loss limitation provisions.

Insurance

The Company has established an Insurance segment for the six months ended June 30, 2008, as a result of the insurance business operated through Island Heritage, a property insurer based in the Cayman Islands which primarily is in the business of insuring homes, condominiums and office buildings in the Caribbean region. The Company gained a controlling interest in Island Heritage in the third quarter of 2007, and as a result, there are no comparatives for the three or six months ended June 30, 2007.

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The following tables provide a summary of gross and net written and earned premiums, underwriting results, total assets, reserves and ratios for each of our business segments for the three and six months ended June 30, 2008 and 2007:

	Three Months Ended June 30, 2008			Three Months Ended June 30, 2007		
	Reinsurance	Insurance	Total	Reinsurance	Insurance	Total
Underwriting Revenues						
Gross premiums written	$ 244,505	$ 26,673	$ 271,178	$ 181,345	$ –	$ 181,345
Premiums ceded	(15,039)	(23,396)	(38,435)	–	–	–
Net written premiums	229,466	3,277	232,743	181,345	–	181,345
Change in net unearned premiums	(95,178)	4,202	(90,976)	(69,503)	–	(69,503)
Net premiums earned	134,288	7,479	141,767	111,842	–	111,842
Other insurance related income	569	(341)	228	197	–	197
Total underwriting revenues	134,857	7,138	141,995	112,039	–	112,039
Underwriting Expenses						
Losses and loss adjustment expenses	56,151	147	56,298	77,257	–	77,257
Acquisition costs	24,074	3,136	27,210	14,725	–	14,725
General and administrative expenses	22,686	1,528	24,214	13,800	–	13,800
Total underwriting expenses	102,911	4,811	107,722	105,782	–	105,782
Underwriting Income	$ 31,946	$ 2,327	$ 34,273	$ 6,257	$ –	$ 6,257
Total Assets	$ 2,349,458	$ 123,718	$ 2,473,176	$ 1,910,448	$ –	$ 1,910,448
Net reserves for loss and loss adjustment expenses	$ 230,546	$ 3,050	$ 233,596	$ 135,143	$ –	$ 135,143
Ratios						
Loss ratio	41.8%	2.0%	39.7%	69.1%	0.0%	69.1%
Acquisition cost ratio	17.9%	41.9%	19.2%	13.2%	0.0%	13.2%
General and administrative expense ratio	16.9%	20.4%	17.1%	12.3%	0.0%	12.3%
Combined ratio	76.6%	64.3%	76.0%	94.6%	0.0%	94.6%

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	Six Months Ended June 30, 2008			Six Months Ended June 30, 2007		
	Reinsurance	Insurance	Total	Reinsurance	Insurance	Total
Underwriting Revenues						
Gross premiums written	$ 467,646	$ 45,778	$ 513,424	$ 388,358	$ –	$ 388,358
Premiums ceded	(20,359)	(34,090)	(54,449)	(8,245)	–	(8,245)
Net written premiums	447,287	11,688	458,975	380,113	–	380,113
Change in net unearned premiums	(184,878)	2,927	(181,951)	(167,045)	–	(167,045)
Net premiums earned	262,409	14,615	277,024	213,068	–	213,068
Other insurance related income	781	488	1,269	422	–	422
Total underwriting revenues	263,190	15,103	278,293	213,490	–	213,490
Underwriting Expenses						
Losses and loss adjustment expenses	95,953	112	96,065	125,005	–	125,005
Acquisition costs	44,984	6,391	51,375	27,443	–	27,443
General and administrative expenses	46,819	3,944	50,763	28,469	–	28,469
Total underwriting expenses	187,756	10,447	198,203	180,917	–	180,917
Underwriting Income	$ 75,434	$ 4,656	$ 80,090	$ 32,573	$ –	$ 32,573
Total Assets	$ 2,349,458	$ 123,718	$ 2,473,176	$ 1,910,448	$ –	$ 1,910,448
Net reserves for loss and loss adjustment expenses	$ 230,546	$ 3,050	$ 233,596			