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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 September 30, 2010

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, S.A.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Luxembourg<br>(State or other jurisdiction of<br>incorporation or organization) | 98-0481623<br>(I.R.S. Employer<br>Identification No.) |

37 Val St André
L-1128 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 þ No o

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 o | Accelerated filer þ |
| Non-accelerated filer o (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 November 2, 2010, the Registrant had 76,588,153 common voting shares outstanding, net of treasury shares with a par value of $0.01 per share.

FLAGSTONE REINSURANCE HOLDINGS, S.A.
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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 September 30, 2010 | As at December 31, 2009 |
|---|---|---|
| ASSETS | | |
| Investments: | | |
| Fixed maturities, at fair value (Amortized cost: 2010 - $1,492,989; 2009 - $1,198,187) | $ 1,563,469 | $ 1,228,561 |
| Short term investments, at fair value (Amortized cost: 2010 - $20,253; 2009 - $231,609) | 19,469 | 232,434 |
| Equity investments, at fair value (Cost: 2010 - $8,091; 2009 - $8,516) | 172 | 290 |
| Other investments | 108,683 | 45,934 |
| Total investments | 1,691,793 | 1,507,219 |
| Cash and cash equivalents | 308,962 | 352,185 |
| Restricted cash | 51,266 | 85,916 |
| Premium balances receivable | 403,861 | 278,956 |
| Unearned premiums ceded | 90,084 | 52,690 |
| Reinsurance recoverable | 27,834 | 19,270 |
| Accrued interest receivable | 14,007 | 11,223 |
| Receivable for investments sold | 26,321 | 5,160 |
| Deferred acquisition costs | 74,779 | 54,637 |
| Funds withheld | 25,806 | 22,168 |
| Goodwill | 16,405 | 16,533 |
| Intangible assets | 31,963 | 35,790 |
| Assets held for sale | 11,000 | - |
| Other assets | 123,392 | 125,021 |
| Total assets | $ 2,897,473 | $ 2,566,768 |
| | | |
| LIABILITIES | | |
| Loss and loss adjustment expense reserves | $ 683,278 | $ 480,660 |
| Unearned premiums | 497,011 | 330,416 |
| Insurance and reinsurance balances payable | 78,430 | 62,864 |
| Payable for investments purchased | 17,205 | 11,457 |
| Long term debt | 251,472 | 252,402 |
| Other liabilities | 87,688 | 63,155 |
| Total liabilities | 1,615,084 | 1,200,954 |
| | | |
| EQUITY | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Common voting shares, 300,000,000 authorized, $0.01 par value, issued and outstanding (2010 - 76,588,153; 2009 - 82,985,219) | | 850 | | | 850 | |
| Common shares held in treasury, at cost (2010 - 8,405,106; 2009 - 2,000,000) | | (84 | ) | | (20 | ) |
| Additional paid-in capital | | 830,107 | | | 892,817 | |
| Accumulated other comprehensive loss | | (6,319 | ) | | (6,976 | ) |
| Retained earnings | | 399,499 | | | 324,347 | |
| Total Flagstone shareholders' equity | | 1,224,053 | | | 1,211,018 | |
| Noncontrolling interest in subsidiaries | | 58,336 | | | 154,796 | |
| Total equity | | 1,282,389 | | | 1,365,814 | |
| Total liabilities and equity | $ | 2,897,473 | | $ | 2,566,768 | |

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

| | For the three months ended September 30, 2010 | For the three months ended September 30, 2009 | For the nine months ended September 30, 2010 | For the nine months ended September 30, 2009 |
|---|---|---|---|---|
| REVENUES | | | | |
| Gross premiums written | $185,649 | $174,590 | $955,462 | $864,784 |
| Premiums ceded | (26,273) | (39,781) | (178,463) | (175,192) |
| Net premiums written | 159,376 | 134,809 | 776,999 | 689,592 |
| Change in net unearned premiums | 39,318 | 60,708 | (129,411) | (134,264) |
| Net premiums earned | 198,694 | 195,517 | 647,588 | 555,328 |
| Net investment income | 7,488 | 10,779 | 22,992 | 19,672 |
| Net realized and unrealized gains - investments | 40,165 | 21,286 | 37,305 | 26,469 |
| Net realized and unrealized gains - other | 7,677 | 1,373 | 11,369 | 11,273 |
| Other income | 1,785 | 4,269 | 19,357 | 11,771 |
| Total revenues | 255,809 | 233,224 | 738,611 | 624,513 |
| | | | | |
| EXPENSES | | | | |
| Loss and loss adjustment expenses | 119,089 | 80,175 | 398,331 | 214,410 |
| Acquisition costs | 30,615 | 35,224 | 119,036 | 99,464 |
| General and administrative expenses | 49,338 | 35,266 | 133,235 | 104,144 |
| Interest expense | 2,690 | 2,814 | 7,749 | 9,490 |
| Net foreign exchange losses | 17,072 | 2,390 | 5,260 | 3,125 |
| Total expenses | 218,804 | 155,869 | 663,611 | 430,633 |
| Income before income taxes and interest in earnings of equity investments | 37,005 | 77,355 | 75,000 | 193,880 |
| Provision for income tax | (966) | (532) | (4,256) | (76) |
| Interest in earnings of equity investments | (364) | (370) | (906) | (1,048) |
| Net income | 35,675 | 76,453 | 69,838 | 192,756 |
| Less: Loss (income) attributable to noncontrolling interest | 1,586 | (9,323) | 12,196 | (22,069) |
| NET INCOME ATTRIBUTABLE TO FLAGSTONE | $37,261 | $67,130 | $82,034 | $170,687 |
| | | | | |
| Net income | $35,675 | $76,453 | $69,838 | $192,756 |
| Change in currency translation adjustment | 5,352 | (4,656) | 471 | 2,610 |
| Change in defined benefit pension plan obligation | 83 | 480 | 186 | 159 |
| Comprehensive income | 41,110 | 72,277 | 70,495 | 195,525 |
| Less: Comprehensive loss (income) attributable to noncontrolling interest | 1,586 | (9,577) | 12,196 | (23,899) |
| | $42,696 | $62,700 | $82,691 | $171,626 |

| | | | | |
|---|---|---|---|---|
| COMPREHENSIVE INCOME ATTRIBUTABLE TO FLAGSTONE | | | | |
| | | | | |
| Weighted average common shares outstanding—Basic | 77,631,156 | 84,004,784 | 79,871,964 | 84,711,027 |
| Weighted average common shares outstanding—Diluted | 77,772,847 | 84,176,602 | 80,071,159 | 84,909,340 |
| Net income attributable to Flagstone per common share—Basic | $0.48 | $0.80 | $1.03 | $2.01 |
| Net income attributable to Flagstone per common share—Diluted | $0.48 | $0.80 | $1.02 | $2.01 |
| Distributions declared per common share (1) | $0.04 | $0.04 | $0.12 | $0.12 |

(1) Distributions declared per common share are in the form of a non-dividend return of capital. Prior to the Company's redomestication to Luxembourg on May 17, 2010, such distributions were in the form of dividends.

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 nine months ended September 30, 2010 | Total equity | Comprehensive income | Retained earnings | Flagstone Shareholders' Equity Accumulated other comprehensive loss | Common voting shares | Additional paid-in capital | Noncontrolling interest in subsidiaries |
|---|---|---|---|---|---|---|---|
| Beginning balance | $1,365,814 | $ - | $324,347 | $ (6,976 ) | $830 | $892,817 | $ 154,796 |
| Redemption of preferred shares | (79,529 ) | | | | | | (79,529 ) |
| Comprehensive income: | | | | | | | |
| Net income | 69,838 | 69,838 | 82,034 | | | | (12,196 ) |
| Other comprehensive income: | | | | | | | |
| Change in currency translation adjustment | 471 | 471 | | 471 | | | |
| Defined benefit pension plan obligation | 186 | 186 | | 186 | | | |
| | 657 | 657 | | | | | |
| Comprehensive income | 70,495 | $ 70,495 | | | | | |
| Stock based compensation | 13,278 | | | | | 13,278 | |
| Subsidiary stock based compensation | (274 ) | | | | | | (274 ) |
| Purchase of noncontrolling interest | (750 ) | | | | | (411 ) | (339 ) |
| Shares repurchased and held in treasury | (72,427 ) | | | | (64 ) | (72,363 ) | |
| Distributions declared per common share | (14,218 ) | | (6,882 ) | | | (3,214 ) | (4,122 ) |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| (1) | | | | | | | |
| Ending balance | $1,282,389 | | $399,499 | $ (6,319 ) | $766 | $830,107 | $ 58,336 |

| | | | Flagstone Shareholders' Equity | | | | |
|---|---|---|---|---|---|---|---|
| For the nine months ended September 30, 2009 | Total equity | Comprehensive income | Retained earnings | Accumulated other comprehensive loss | Common voting shares | Additional paid-in capital | Noncontrolling interest in subsidiaries |
| Beginning balance | $1,183,463 | $ - | $96,092 | $ (8,271 ) | $848 | $897,344 | $ 197,450 |
| Redemption of preferred shares | (63,117 ) | | | | | | (63,117 ) |
| Comprehensive income: | | | | | | | |
| Net income | 192,756 | 192,756 | 170,687 | | | | 22,069 |
| Other comprehensive income: | | | | | | | |
| Change in currency translation adjustment | 2,610 | 2,610 | | 780 | | | 1,830 |
| Defined benefit pension plan obligation | 159 | 159 | | 159 | | | |
| | 2,769 | 2,769 | | | | | |
| Comprehensive income | 195,525 | $ 195,525 | | | | | |
| Stock based compensation | 10,399 | | | | | 10,399 | |
| Subsidiary stock based compensation | 14 | | | | | | 14 |
| Subsidiary stock issuance | - | | | | | (184 ) | 184 |
| Purchase of noncontrolling interest | (84 ) | | | | | | (84 ) |
| Issue of shares, net | 1 | | | | 1 | | |
| Shares repurchased and held in treasury | (19,750 ) | | | | (20 ) | (19,730 ) | |
| Distributions declared per common share (1) | (10,490 ) | | (10,490 ) | | | | |
| Ending balance | $1,295,961 | | $256,289 | $ (7,332 ) | $829 | $887,829 | $ 158,346 |

(1) Distributions declared per common share are in the form of a non-dividend return of capital. Prior to the Company's redomestication to Luxembourg on May 17, 2010, such distributions were in the form of dividends.

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 CASH FLOWS
(Expressed in thousands of U.S. dollars)

| | For the nine months ended September 30, 2010 | 2009 |
|---|---|---|
| Cash flows provided by (used in) operating activities: | | |
| Net income | $69,838 | $192,756 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net realized and unrealized gains | (48,674) | (37,742) |
| Net unrealized foreign exchange losses | 1,506 | 1,191 |
| Depreciation and amortization expense | 5,776 | 5,204 |
| Share based compensation expense | 12,694 | 10,048 |
| Interest in earnings of equity investments | 906 | 1,048 |
| Accretion/amortization on fixed maturities | 3,301 | 3,039 |
| Changes in assets and liabilities, excluding net assets acquired: | | |
| Premium balances receivable | (124,384) | (157,581) |
| Unearned premiums ceded | (37,369) | (49,241) |
| Deferred acquisition costs | (20,337) | (21,802) |
| Funds withheld | (3,852) | (7,280) |
| Loss and loss adjustment expense reserves | 203,944 | 50,666 |
| Unearned premiums | 167,268 | 182,819 |
| Insurance and reinsurance balances payable | 14,830 | 38,855 |
| Reinsurance recoverable | (9,208) | 1,960 |
| Asset impairment charge | 13,862 | - |
| Other changes in assets and liabilities, net | (17,412) | 46,219 |
| Net cash provided by operating activities | 232,689 | 260,159 |
| | | |
| Cash flows (used in) provided by investing activities: | | |
| Net cash received (paid) in acquisition (disposal) of subsidiaries | (750) | (1,732) |
| Purchases of fixed income securities | (2,797,924) | (1,940,588) |
| Sales and maturities of fixed income securities | 2,713,093 | 1,352,715 |
| Purchases of equity securities | - | (2,006) |
| Sales of equity securities | - | 7,623 |
| Purchases of other investments | (68,442) | (8,446) |
| Sales of other investments | 35,283 | 9,998 |
| Purchases of fixed assets | (28,471) | (10,726) |
| Sales of fixed assets | 1,563 | 145 |
| Change in restricted cash | 34,650 | (9,967) |
| Net cash used in investing activities | (110,998) | (602,984) |
| | | |
| Cash flows (used in) provided by financing activities: | | |
| Shares repurchased and held in treasury | (72,427) | (19,750) |

| | | |
|---|---|---|
| Contribution of noncontrolling interest | - | 197 |
| Repurchase of noncontrolling interest | (79,529) | (63,117) |
| Distributions paid per common share (1) | (9,507) | (10,100) |
| Repayment of long term debt | - | (15,042) |
| Other | 620 | 621 |
| Net cash used in financing activities | (160,843) | (107,191) |
| | | |
| Effect of foreign exchange rate on cash | (4,071) | 1,041 |
| | | |
| Decrease in cash and cash equivalents | (43,223) | (448,975) |
| Cash and cash equivalents - beginning of year | 352,185 | 783,705 |
| Cash and cash equivalents - end of period | $308,962 | $334,730 |
| | | |
| Supplemental cash flow information: | | |
| Receivable for investments sold | $26,321 | $27,410 |
| Payable for investments purchased | $17,205 | $37,944 |
| Interest paid | $6,967 | $9,338 |

(1) Distributions paid per common share are in the form of a non-dividend return of capital. Prior to the Company's redomestication to Luxembourg on May 17, 2010, such distributions were in the form of dividends.

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

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

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1. ORGANIZATION

On March 22, 2010, Flagstone Reinsurance Holdings Limited, the predecessor to Flagstone Reinsurance Holdings, S.A. ("Flagstone" or the "Company"), announced that its Board of Directors recommended a proposal for a redomestication to change Flagstone's jurisdiction of incorporation from Bermuda to Luxembourg. On May 14, 2010, the Company's shareholders approved the redomestication and Flagstone 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. Flagstone does not expect the redomestication to have a material impact on the way the Company operates or on its financial condition or results of operations.

On May 21, 2010, Mark J. Byrne stepped down as Executive Chairman of the Board of Directors of the Company. In connection with his resignation, Flagstone Holdings (Bermuda) Limited ("Bermuda Holdings"), a subsidiary of the Company, and Mr. Byrne entered into a General Release and Settlement Agreement (the "Release Agreement") which was filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ending June 30, 2010, and filed with the Securities and Exchange Commission (the "SEC") on August 3, 2010. Mr. Byrne continues to serve as a non-executive member of the Board of Directors. David Brown, who has served as Flagstone's Chief Executive Officer since the Company's inception in 2005, and all other members of the senior management team, continue in their current roles. Daniel James, a member of the Board of Directors since the Company's inception, has succeeded Mr. Byrne as Chairman.

Under the terms of the Release Agreement, Bermuda Holdings paid Mr. Byrne a lump-sum cash severance payment of $1.1 million on May 24, 2010, and agreed to pay a second lump-sum cash severance payment of $1.1 million on May 20, 2012, in respect of amounts payable to Mr. Byrne pursuant to the terms of his employment agreement and other compensation rights. All equity, equity-based, bonus or incentive compensation awards (including performance share units under the Company's Amended and Restated Performance Share Unit Plan (the "PSU Plan")) held by Mr. Byrne have been forfeited without payment. The Release Agreement also provides Mr. Byrne with continuation of certain benefits, including medical insurance. Pursuant to the Release Agreement, Mr. Byrne and Bermuda Holdings mutually released one another from, amongst other things, any and all existing liabilities and agreements relating to Mr. Byrne's employment with the Company. The foregoing description does not purport to be complete and is qualified in its entirety by reference to the Release Agreement, which is included as Exhibit 10.1 to Quarterly Report on Form 10-Q for the quarter ending June 30, 2010, and filed with the SEC on August 3, 2010.

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, unless the context otherwise requires. All amounts in the following tables, unless otherwise stated, are expressed in thousands of U.S. dollars, except share amounts, per share amounts and percentages. 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 United States of America 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 intercompany accounts and transactions have been eliminated on consolidation.

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

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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.

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, 2009 (the "Annual Report"), filed with the SEC on March 1, 2010.

3. NEW ACCOUNTING PRONOUNCEMENTS

Adoption of new accounting pronouncements

During the first quarter of 2010, the Company adopted the FASB amendments to ASC Topic 860, "Transfers and Servicing," ("ASC 860") which codified FASB Statement No. 166, "Accounting for Transfers of Financial Assets". ASC 860 requires that a transferor recognize and initially measure at fair value all assets obtained (including a transferor's beneficial interest) and liabilities incurred as a result of financial assets accounted for as a sale. It is a revision to FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities", and requires more information about transfers of financial assets, including securitization transactions, and where entities have continuing exposure to the risks related to transferred financial assets. The effect of adopting ASC 860 did not have a material impact on the consolidated results of operations and financial condition.

During the first quarter of 2010, the Company adopted the amendments to the FASB ASC Topic 810, "Consolidation" ("ASC 810") which codified FASB Statement No. 167, "Amendments to FASB Interpretation No. 46(R)". ASC 810 amends FASB Statement No. 46 (revised December 2003), "Consolidation of Variable Interest Entities", to require an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. It prescribes determination of whether a reporting entity is required to consolidate another entity based on, among other things, the other entity's purpose and design and the reporting entity's ability to direct the activities of the other entity that most significantly impact the other entity's economic performance. The effect of adopting the amendments to ASC 810 did not have a material impact on the consolidated results of operations and financial condition.

In January 2010, the FASB issued Accounting Standards Update No. 2010-06, "Fair Value Measurements and Disclosures (Topic 820) - Improving Disclosures about Fair Value Measurements" ("ASU 2010-06"). This update requires new disclosures about fair value measurements as set forth in the Fair Value Measurements and Disclosures – Overall Subtopic of the FASB ASC. Specifically, this update requires disclosing (1) the amounts of significant transfers in and out of Level 1 and 2 fair value measurements and the reasons for the transfers, and (2) information about purchases, sales, issuances and settlements separately in the reconciliation for fair value measurements using significant unobservable inputs. The ASU 2010-06 was effective for interim and annual periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The Company adopted the relevant portions of ASU 2010-06 in the first quarter of 2010, and the effect of adopting the update did not have a material impact on the consolidated results of operations and financial condition.

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

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New accounting pronouncements

In October 2010, the FASB issued Accounting Standards Update No. 2010-26, “Financial Services and Insurance (Topic 944) – Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts” (“ASU 2010-26”). The objective of ASU 2010-26 is to address diversity in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. ASU 2010-26 is effective for interim and annual periods beginning after December 15, 2011. The Company is currently assessing the potential impact, if any, of the adoption of ASU 2010-26 on its consolidated results of operations and financial condition.

4. INVESTMENTS

Fixed maturity, short term, equity and other investments

The cost or amortized cost, gross unrealized gains and losses and carrying values as at September 30, 2010 and December 31, 2009 are as follows:

| | As at September 30, 2010 | | | |
|---|---|---|---|---|
| | Amortized cost or cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| Fixed maturity investments | | | | |
| U.S. government and government agency | $264,748 | $8,118 | $(68) | $272,798 |
| U.S. states and political subdivision | 1,594 | 11 | - | 1,605 |
| Other foreign governments | 268,012 | 20,491 | (1) | 288,502 |
| Corporates | 581,872 | 32,833 | (406) | 614,299 |
| Mortgage-backed securities | 232,474 | 6,547 | (320) | 238,701 |
| Asset-backed securities | 144,289 | 3,341 | (66) | 147,564 |
| | 1,492,989 | 71,341 | (861) | 1,563,469 |
| | | | | |
| Short term investments | | | | |
| U.S. government and government agency | 1,000 | - | - | 1,000 |
| Other foreign governments | 717 | - | - | 717 |
| Corporates | 18,536 | 4 | (788) | 17,752 |
| | 20,253 | 4 | (788) | 19,469 |
| | | | | |
| Equity investments | 8,091 | 4 | (7,923) | 172 |
| | 8,091 | 4 | (7,923) | 172 |
| | | | | |
| Other investments | | | | |
| Investment funds | 34,398 | 1,021 | (6,947) | 28,472 |

| | | | | |
|---|---|---|---|---|
| Catastrophe bonds | 75,474 | 1,439 | (116) | 76,797 |
| | 109,872 | 2,460 | (7,063) | 105,269 |
| | | | | |
| Totals | $1,631,205 | $73,809 | $(16,635) | $1,688,379 |

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

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| | As at December 31, 2009 | | | |
|---|---|---|---|---|
| | Amortized cost or cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| Fixed maturity investments | | | | |
| U.S. government and government agency | $421,215 | $12,186 | $(1,686) | $431,715 |
| U.S. states and political subdivision | 1,907 | 11 | (15) | 1,903 |
| Other foreign governments | 112,119 | 3,426 | (1,118) | 114,427 |
| Corporates | 504,855 | 15,763 | (1,376) | 519,242 |
| Mortgage-backed securities | 108,652 | 3,969 | (554) | 112,067 |
| Asset-backed securities | 49,439 | 253 | (485) | 49,207 |
| | 1,198,187 | 35,608 | (5,234) | 1,228,561 |
| | | | | |
| Short term investments | | | | |
| U.S. government and government agency | 145,600 | 6 | (2) | 145,604 |
| Other foreign governments | 3,877 | 136 | - | 4,013 |
| Corporates | 80,223 | 1,419 | (738) | 80,904 |
| Asset-backed securities | 1,909 | 4 | - | 1,913 |
| | 231,609 | 1,565 | (740) | 232,434 |
| | | | | |
| Equity investments | 8,516 | 124 | (8,350) | 290 |
| | 8,516 | 124 | (8,350) | 290 |
| | | | | |
| Other investments | | | | |
| Investment funds | 13,239 | - | (7,753) | 5,486 |
| Catastrophe bonds | 35,777 | 402 | (51) | 36,128 |
| | 49,016 | 402 | (7,804) | 41,614 |
| | | | | |
| Totals | $1,487,328 | $37,699 | $(22,128) | $1,502,899 |

For reconciliation purposes, other investments does not include an investment accounted for under the equity method in which the Company is deemed to have a significant influence and as such, is not accounted for at fair value under the FASB ASC guidance for financial instruments. This investment is recorded at $3.4 million and $4.3 million at September 30, 2010 and December 31, 2009, respectively.

The following table presents the contractual maturity dates of fixed maturities and short term investments as at September 30, 2010 and December 31, 2009:

| | As at September 30, 2010 | | As at December 31, 2009 | |
|---|---|---|---|---|
| | Amortized cost | Fair value | Amortized cost | Fair value |
| Due within one year | $46,059 | $46,198 | $308,865 | $312,253 |
| Due after 1 through 5 years | 826,132 | 865,384 | 577,634 | 588,707 |
| Due after 5 through 10 years | 173,533 | 185,685 | 311,819 | 324,095 |
| Due after 10 years | 90,755 | 99,406 | 71,478 | 72,753 |
| Mortgage and asset-backed securities | 376,763 | 386,265 | 160,000 | 163,187 |
| Total | $1,513,242 | $1,582,938 | $1,429,796 | $1,460,995 |

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

The following table presents a breakdown of the credit quality of the Company's fixed maturities and short term investments at September 30, 2010 and December 31, 2009:

| | As at September 30, 2010 | | | | As at December 31, 2009 | | | |
|---|---|---|---|---|---|---|---|---|
| | | Fair value | Percentage of total | | | Fair value | Percentage of total | |
| Rating Category | | | | | | | | |
| AAA | $ | 991,396 | 62.6 | % | $ | 1,043,223 | 71.4 | % |
| AA | | 208,192 | 13.2 | % | | 111,300 | 7.6 | % |
| A | | 270,537 | 17.1 | % | | 214,214 | 14.7 | % |
| BBB | | 112,813 | 7.1 | % | | 91,723 | 6.3 | % |
| Below investment grade | | - | 0.0 | % | | 535 | 0.0 | % |
| Total | $ | 1,582,938 | 100.0 | % | $ | 1,460,995 | 100.0 | % |

We have included credit rating information with respect to our investments portfolio because it enhances the reader's understanding of its composition and consistency with our investment philosophy.

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 determined that its investments in U.S. government treasury securities and listed equity securities are stated at Level 1 fair value as determined by the quoted market price of these securities, as provided either by independent pricing services or exchange market prices.

Investments in U.S. government agency securities, corporate bonds, mortgage-backed securities, foreign government bonds and asset-backed securities are stated at Level 2 fair value. 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 stated at Level 2 fair value as determined by reference to broker indications. Those indications are based on current market conditions, including liquidity and transactional history, recent issue price of similar catastrophe bonds and seasonality of the underlying risks.

The Level 3 investments are reviewed by the Company along with the valuation methods. The fair value of the private equity investment funds is determined by the investment fund managers using the net asset value provided by the administrator or manager of the funds on a quarterly basis and fair value adjustments where it is deemed appropriate based on analysis and discussions with the fund managers. The fair value of the mortgage-backed investment fund 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.

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As at September 30, 2010 and December 31, 2009, the Company's investments are allocated among fair value levels as follows:

| | Fair Value Measurement at September 30, 2010, 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 | $ 272,798 | $ 175,303 | $ 97,495 | $ - |
| U.S. states and political subdivisions | 1,605 | - | 1,605 | - |
| Other foreign government | 288,502 | - | 288,502 | - |
| Corporates | 614,299 | - | 614,299 | - |
| Mortgage-backed securities | 238,701 | - | 238,701 | - |
| Asset-backed securities | 147,564 | - | 147,564 | - |
| | 1,563,469 | 175,303 | 1,388,166 | - |
| | | | | |
| Short term investments | | | | |
| U.S. government and agency securities | 1,000 | - | 1,000 | - |
| Other foreign government | 717 | - | 717 | - |
| Corporates | 17,752 | - | 17,752 | - |
| | 19,469 | - | 19,469 | - |
| | | | | |
| Equity investments | | | | |
| Financial services | 172 | 172 | - | - |
| | 172 | 172 | - | - |
| | | | | |
| Other investments | | | | |
| Investment funds | 28,471 | - | - | 28,471 |
| Catastrophe bonds | 76,798 | - | 76,798 | - |
| | 105,269 | - | 76,798 | 28,471 |
| | | | | |
| Totals | $ 1,688,379 | $ 175,475 | $ 1,484,433 | $ 28,471 |

For the Level 3 items still held as of September 30, 2010, the total change in fair value is $1.8 million for both the three and nine months ended September 30, 2010. 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 nine month periods.

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| | Fair Value Measurement at December 31, 2009, using: | | | |
|---|---|---|---|---|
| | Fair value measurements | Quoted prices in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant other unobservable inputs (Level 3) |
| Fixed maturity investments | | | | |
| U.S. government and agency securities | $ 431,715 | $ 380,843 | $ 50,872 | $ - |
| U.S. states and political subdivisions | 1,903 | - | 1,903 | - |
| Other foreign government | 114,427 | - | 114,427 | - |
| Corporates | 519,242 | - | 519,242 | - |
| Mortgage-backed securities | 112,067 | - | 111,290 | 777 |
| Asset-backed securities | 49,207 | - | 47,686 | 1,521 |
| | 1,228,561 | 380,843 | 845,420 | 2,298 |
| | | | | |
| Short term investments | | | | |
| U.S. government and agency securities | 145,604 | 125,755 | 19,849 | - |
| Other foreign government | 4,013 | - | 4,013 | - |
| Corporates | 80,904 | - | 80,904 | - |
| Asset-backed securities | 1,913 | - | 1,913 | - |
| | 232,434 | 125,755 | 106,679 | - |
| Equity investments | | | | |
| Financial services | 290 | 290 | - | - |
| | 290 | 290 | - | - |
| | | | | |
| Other investments | | | | |
| Investment funds | 5,486 | - | - | 5,486 |
| Catastrophe bonds | 36,128 | - | 36,128 | - |
| | 41,614 | - | 36,128 | 5,486 |
| | | | | |
| Totals | $ 1,502,899 | $ 506,888 | $ 988,227 | $ 7,784 |

For reconciliation purposes, other investments does not include an investment accounted for under the equity method in which the Company is deemed to have a significant influence and as such, is not accounted for at fair value under the FASB ASC guidance for financial instruments. This investment is recorded at $3.4 million and $4.3 million at September 30, 2010 and December 31, 2009, respectively.

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The reconciliation of the fair value for the Level 3 investments for the nine months ended September 30, 2010, including purchases and sales and change in realized and unrealized gains (losses) in earnings, is set out below:

| | For the nine months ended September 30, 2010 | | |
|---|---|---|---|
| | Fixed maturities | Investment funds | Total |
| Fair value, December 31, 2009 | $2,298 | $5,486 | $7,784 |
| Total realized losses included in earnings | (226) | - | (226) |
| Total unrealized gains included in earnings | 512 | 58 | 570 |
| Purchases | - | 190 | 190 |
| Sales | (2,584) | - | (2,584) |
| Fair value, March 31, 2010 | $- | $5,734 | $5,734 |
| Total realized losses included in earnings | - | - | - |
| Total unrealized gains included in earnings | - | 4 | 4 |
| Purchases | - | 17,080 | 17,080 |
| Sales | - | - | - |
| Fair value, June 30, 2010 | $- | $22,818 | $22,818 |
| Total realized losses included in earnings | - | - | - |
| Total unrealized gains included in earnings | - | 1,764 | 1,764 |
| Purchases | - | 3,889 | 3,889 |
| Sales | - | - | - |
| Fair value, September 30, 2010 | $- | $28,471 | $28,471 |

Pledged assets

The Company holds cash and cash equivalents and fixed maturity securities 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 cash and cash equivalents and fixed maturity securities as at September 30, 2010 and December 31, 2009, respectively are as follows:

| | As at September 30, 2010 | As at December 31, 2009 |
|---|---|---|
| Cash and cash equivalents | $ 51,266 | $ 85,916 |
| Fixed maturity securities | 474,132 | 425,109 |
| Total | $ 525,398 | $ 511,025 |

Other investments

The catastrophe bonds held 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 and mortgage-backed investment funds. As at September 30, 2010 and December 31, 2009, the Company had total outstanding investment commitments of $20.4 million and $3.4 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 does not expect to redeem a significant portion of these investments prior to 2016.

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The following table presents the fair value of the Company's investments funds as at September 30, 2010 and December 31, 2009:

| | As at September 30, 2010 Fair value | As at December 31, 2009 Fair value |
|---|---|---|
| Private equity funds | $ 7,450 | $ 5,486 |
| Mortgage-backed investment funds | 21,021 | - |
| Total | $ 28,471 | $ 5,486 |

## 5. 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.

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 and total return swaps to gain exposure to the underlying asset or index. The Company also purchases "to be announced" mortgage-backed securities ("TBA") as part of its investing activities. The Company manages the exposure to these instruments based on guidelines established by management and approved by the Company's Board of Directors.

The Company has entered into certain foreign currency forward contracts in order to hedge 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.

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The details of the derivatives held by the Company as of September 30, 2010 and December 31, 2009 are as follows:

| | As at September 30, 2010 | | | |
|---|---|---|---|---|
| | 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) | $ - | $ 230 | $ 42,796 | $ (230) |
| | - | 230 | | (230) |
| | | | | |
| Derivatives not designated as hedging instruments | | | | |
| Purpose - risk management | | | | |
| Currency swaps | $ - | $ 670 | $ 17,725 | $ (670) |
| Foreign currency forward contracts | 8,615 | 35,784 | 810,159 | (27,169) |
| Futures contracts | 526 | 6,907 | 958,701 | (6,381) |
| | 9,141 | 43,361 | | (34,220) |
| Purpose - exposure | | | | |
| Futures contracts | $ 6,528 | $ 44 | $ 176,536 | $ 6,484 |
| Mortgage-backed securities TBA | 2 | 9 | 3,980 | (7) |
| Other reinsurance derivatives | - | 66 | - | (66) |
| | 6,530 | 119 | | 6,411 |
| | | | | |
| Total derivatives | $ 15,671 | $ 43,710 | | $ (28,039) |

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| | As at December 31, 2009 | | | |
|---|---|---|---|---|
| | 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) | $ 148 | $ 512 | $ 88,312 | $ (364) |
| | 148 | 512 | | (364) |
| | | | | |
| Derivatives not designated as hedging instruments | | | | |
| Purpose - risk management | | | | |
| Currency swaps | $ 260 | $ - | $ 18,655 | $ 260 |
| Foreign currency forward contracts | 12,532 | 6,386 | 288,832 | 6,146 |
| | 12,792 | 6,386 | | 6,406 |
| Purpose - exposure | | | | |
| Futures contracts | $ 3,847 | $ - | $ 150,770 | $ 3,847 |
| Total return swaps | 409 | 436 | 45,948 | (27) |
| Mortgage-backed securities TBA | - | 399 | 41,496 | (399) |
| Other reinsurance derivatives | - | 1,596 | | (1,596) |
| | 4,256 | 2,431 | | 1,825 |
| | | | | |
| Total derivatives | $ 17,196 | $ 9,329 | | $ 7,867 |

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

Designated

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

| | 2010 | 2009 | Location | 2010 | 2009 |
|---|---|---|---|---|---|
| Foreign currency forward contracts (1) | $(4,270) | $(2,132) | Net realized and unrealized (losses) - other | $(206) | $(404) |
| | $(4,270) | $(2,132) | | $(206) | $(404) |

| Derivatives designated as hedging instruments | Amount of Gain or (Loss) on Derivatives Recognized in Comprehensive income (loss) (Effective portion) For the nine months ended September 30, | | | Net income (loss) (Ineffective portion) For the nine months ended September 30, | |
|---|---|---|---|---|---|
| | 2010 | 2009 | Location | 2010 | 2009 |
| Foreign currency forward contracts (1) | $200 | $(4,519) | Net realized and unrealized (losses) - other | $(478) | $(1,107) |
| | $200 | $(4,519) | | $(478) | $(1,107) |

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

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Non-Designated

| Derivatives not designated as hedging instruments | Location | Gain or (Loss) on Derivatives Recognized in Net Income — For the three months ended September 30, 2010 | 2009 |
|---|---|---|---|
| Futures contracts | Net realized and unrealized gains (losses) - investments | $ 17,144 | $ (1,041 ) |
| Total return swaps | Net realized and unrealized gains - investments | - | 2,036 |
| Currency swaps | Net realized and unrealized gains - other | 1,818 | 819 |
| Foreign currency forward contracts | Net realized and unrealized (losses) - investments | (70,393 ) | (12,365 ) |
| Foreign currency forward contracts | Net realized and unrealized gains - other | 5,495 | 535 |
| Mortgage-backed securities TBA | Net realized and unrealized gains - investments | 2 | 1,100 |
| Other reinsurance derivatives | Net realized and unrealized gains - other | 570 | 423 |
| | | $ (45,364 ) | $ (8,493 ) |

| Derivatives not designated as hedging instruments | Location | Gain or (Loss) on Derivatives Recognized in Net Income — For the nine months ended September 30, 2010 | 2009 |
|---|---|---|---|
| Futures contracts | Net realized and unrealized (losses) gains - investments | $ (3,209 ) | $ 3,261 |
| Total return swaps | Net realized and unrealized gains (losses) - investments | 1,105 | (5,866 ) |
| Currency swaps | Net realized and unrealized (losses) gains - other | (948 ) | 1,012 |
| Foreign currency forward contracts | Net realized and unrealized (losses) - investments | (21,977 ) | (31,909 ) |
| Foreign currency forward contracts | Net realized and unrealized gains - other | 11,106 | 9,897 |
| Mortgage-backed securities TBA | Net realized and unrealized gains - investments | 890 | 2,241 |

| | | | |
|---|---|---|---|
| Other reinsurance derivatives | Net realized and unrealized gains - other | 1,689 | 1,471 |
| | | $ (11,344) | $ (19,893) |

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. All other foreign currency forward contracts are not designated as hedges and are entered into for the purposes of currency risk management.

Futures contracts

The Company uses futures contracts to gain exposure to certain markets or indexes and to hedge interest rate risk. The Company has entered into equity index, commodity index and interest rate futures as part of its investment strategy.

Total return swaps

The Company uses total return swaps to gain exposure to a global inflation linked bond index and a global equity index. 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.

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.

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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.

Fair value disclosure

In accordance with the Fair Value Measurements and Disclosures Topic of the FASB ASC, the fair value of derivative instruments held as at September 30, 2010 and December 31, 2009 is allocated between levels as follows:

| | Fair Value Measurement at September 30, 2010, using: | | | |
|---|---|---|---|---|
| Description | Fair value measurements | Quoted prices in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant other unobservable inputs (Level 3) |
| Futures contracts | $ 103 | $ 103 | $ - | $ - |
| Swaps | (670) | - | (670) | - |
| Foreign currency forward contracts | (27,399) | - | (27,399) | - |
| Mortgage-backed securities TBA | (7) | - | (7) | - |
| Other reinsurance derivatives | (66) | - | - | (66) |
| Total derivatives | $ (28,039) | $ 103 | $ (28,076) | $ (66) |

For the Level 3 items still held as of September 30, 2010, the total change in fair value recorded in net realized and unrealized gains (losses) – other for the three and nine months ended September 30, 2010 is a $0.6 million gain and $0.2 million loss, respectively.

| | Fair Value Measurement at December 31, 2009, using: | | | |
|---|---|---|---|---|
| Description | Fair value measurements | Quoted prices in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant other unobservable inputs (Level 3) |
| Futures contracts | $ 3,847 | $ 3,847 | $ - | $ - |
| Swaps | 233 | - | 233 | - |

| | | | | |
|---|---|---|---|---|
| Foreign currency forward contracts | 5,782 | - | 5,782 | - |
| Mortgage-backed securities TBA | (399 ) | - | (399 ) | - |
| Other reinsurance derivatives | (1,596 ) | - | - | (1,596 ) |
| Total derivatives | $ 7,867 | $ 3,847 | $ 5,616 | $ (1,596 ) |

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

| | | For the nine months ended September 30, 2010 |
|---|---|---|
| Other reinsurance derivatives | | |
| Fair value, December 31, 2009 | $ | (1,596) |
| Total premium earned included in earnings | | 642 |
| Purchases | | (250) |
| Sales | | - |
| Fair value, March 31, 2010 | $ | (1,204) |
| Total premium earned included in earnings | $ | 563 |
| Purchases | | - |
| Sales | | - |
| Fair value, June 30, 2010 | $ | (641) |
| Total premium earned included in earnings | $ | 575 |
| Purchases | | - |
| Sales | | - |
| Fair value, September 30, 2010 | $ | (66) |

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 any of these periods.

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## 6. GOODWILL AND INTANGIBLES

| Goodwill relates to the following reportable segments: | Reinsurance | Lloyd's | Island Heritage | Total |
|---|---|---|---|---|
| Balance as at December 31, 2009 | $ 3,144 | $ 3,339 | $ 10,050 | $ 16,533 |
| Impact of foreign exchange | (36) | (92) | - | (128) |
| Balance as at September 30, 2010 | $ 3,108 | $ 3,247 | $ 10,050 | $ 16,405 |

| Finite life intangibles | Carrying value at beginning of period | Impairment loss | Accumulated amortization (1) | Impact of foreign exchange | Carrying value at end of period |
|---|---|---|---|---|---|
| Tradename | $ 1,308 | $ (1,173) | $ - | $ (135) | $ - |
| Software | 3,924 | - | (306) | (119) | 3,499 |
| Distribution network | 3,356 | - | (229) | (101) | 3,026 |
| | $ 8,588 | $ (1,173) | $ (535) | $ (355) | $ 6,525 |
| Indefinite life intangibles | | | | | |
| Lloyd's syndicate capacity | $ 25,353 | $ - | $ - | $ (690) | $ 24,663 |
| Licenses | 1,849 | (1,074) | - | - | 775 |
| | $ 27,202 | $ (1,074) | $ - | $ (690) | $ 25,438 |
| Aggregate amortization expenses (1) | | | | | |
| For the nine months ended September 30, 2010 | | | | | $ 603 |

| Estimated amortization expense | For the years ending December 31, | Amount |
|---|---|---|
| | 2010 | $ 809 |
| | 2011 | 708 |
| | 2012 | 681 |
| | 2013 | 656 |
| | 2014 | 634 |

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

During the second quarter of 2010, the Company recognized an impairment charge of $1.1 million related to a license classified as an indefinite life intangible. During the third quarter of 2010, the Company recognized an impairment charge of $1.2 million related to a tradename classified as a finite life intangible. The impairment charges are included in general and administrative expenses on the unaudited condensed consolidated statements of operations and comprehensive income.

7. ASSETS HELD FOR SALE

On August 2, 2010, and September 30, 2010, respectively, the Company terminated operational lease agreements for two aircraft, with Banc of America Leasing, at the casualty value stipulated in the lease agreements. Following the purchase of these leased aircraft, the aggregate carrying value of these aircraft was $22.6 million. The Company estimates the current market value of these aircraft to be approximately $11.0 million. Therefore, the Company recorded impairment charges in its Reinsurance segment of $11.6 million in the third quarter of 2010. The impairment charges are included in general and administrative expenses on the unaudited condensed consolidated statements of operations and comprehensive income. The Company intends to sell these aircraft and therefore they have been reflected as assets held for sale on the unaudited condensed consolidated balance sheet as at September 30, 2010.

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## 8. MONT FORT RE LIMITED

On June 3, 2010, Mont Fort Re Limited ("Mont Fort") repurchased 17.3 million preferred shares relating to its second cell, Mont Fort ILW 2, for $32.0 million.

On July 27, 2010, Mont Fort repurchased 32.7 million preferred shares relating to its second cell, Mont Fort ILW 2, for $47.5 million.

The Company has considered the implications of these share repurchases as they relate to the FASB ASC Topic on Consolidations, specifically relating to variable interest entities, and has concluded that the Company remains the primary beneficiary and should continue to consolidate Mont Fort.

## 9. 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 nine months ended September 30, 2010, the Company incurred interest expense of $2.4 million and $7.0 million, respectively, on the Deferrable Interest Debentures compared to $2.8 million and $9.5 million, respectively, for the same periods in 2009. Also, at both September 30, 2010 and December 31, 2009, the Company had $0.8 million of interest payable included in other liabilities.

The Company does not carry its long term debt at fair value on its consolidated balance sheets. At September 30, 2010, the Company estimated the fair value of its long term debt to be approximately $222.0 million compared to $203.9 million at December 31, 2009.

Letter of credit facilities

On June 5, 2009, Flagstone Suisse entered into a secured $50.0 million standby letter of credit facility with BNP Paribas (the "BNP Facility"). The BNP Facility had an initial term of one year and the Company decided to let the facility expire as per the terms of the agreement effective June 4, 2010.

On March 5, 2009, Flagstone Suisse entered into a $200.0 million secured committed letter of credit facility with Barclays Bank Plc (the "Barclays Facility"). The Barclays Facility is used to support the reinsurance obligations of the Company and its subsidiaries. As at September 30, 2010, $32.3 million had been drawn under the Barclays Facility, and the drawn amount was secured by $35.9 million of fixed maturity securities from the Company's investment portfolio.

On April 28, 2010, Flagstone Suisse and Flagstone Capital Management Luxembourg SICAF – FIS entered into a secured $450.0 million standby letter of credit facility with Citibank Europe Plc (the "Citi Facility"). The Citi Facility comprises 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 its subsidiaries, 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. As at September 30, 2010, $388.1 million had been drawn under the Citi Facility, and the drawn amount of the facility was secured by $435.5 million of fixed maturity securities from the Company's investment portfolio. This facility replaces 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 are collateralized by the Company, at least to the extent of the letters of credit outstanding at any given time.

10. 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").

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Performance Share Units

The Company's PSU Plan is the Company's shareholder approved primary executive long term incentive scheme. Pursuant to the terms of the PSU Plan, at the discretion of the Compensation Committee of the Board of Directors, 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.

At the Company's Annual General Meeting of shareholders held on May 14, 2010, the PSU Plan was amended to modify the treatment of PSUs upon the retirement of an employee and to cancel PSUs if (a) the Company is required to make a financial restatement due to a material misstatement and (b) those PSUs were granted based upon the erroneous financial information.

A summary of the activity under the PSU Plan as at September 30, 2010, and changes during the three and nine months ended September 30, 2010 is as follows:

| | For the three months ended September 30, 2010 | | | For the nine months ended September 30, 2010 | | |
|---|---|---|---|---|---|---|
| | 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 | 4,095,175 | $10.22 | 1.4 | 3,305,713 | $10.04 | 1.6 |
| Granted | - | - | | 824,500 | 10.94 | |
| Forfeited | (150,117 ) | 10.32 | | (185,155 ) | 10.28 | |
| Outstanding at end of period | 3,945,058 | 10.22 | 1.1 | 3,945,058 | 10.22 | 1.1 |

The Company reviews its assumptions in relation to the PSUs on a quarterly basis. For the three and nine months ended September 30, 2010, $3.1 million and $11.0 million, respectively, of compensation expense has been recorded in general and administrative expenses in relation to the PSU Plan compared to $2.7 million and $7.9 million, respectively, for the same periods in 2009. The issuance of shares with respect to the PSUs is contingent upon the attainment of certain levels of average DROE over a two or three year period. As at September 30, 2010 and December 31, 2009, there was a total of $15.4 million and $19.4 million, respectively, of unrecognized compensation cost related to non-vested PSUs; that cost is expected to be recognized over a period of approximately 1.6 years and 1.6 years, respectively.

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

Restricted Share Units

The purpose of the Company's Amended and Restated Employee 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 whereas RSUs granted to directors vest on the grant date.

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A summary of the activity under the RSU Plan as at September 30, 2010 and changes during the three and nine months ended September 30, 2010, are as follows:

| | For the three months ended September 30, 2010 | | | For the nine months ended September 30, 2010 | | |
|---|---|---|---|---|---|---|
| | 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 | 565,923 | $ 11.00 | 0.5 | 373,157 | $ 10.89 | 0.5 |
| Granted | 23,315 | 10.16 | | 251,136 | 10.97 | |
| Forfeited | (33,300) | 10.21 | | (60,315) | 10.16 | |
| Exercised in the period | - | - | | (8,040) | 10.51 | |
| Outstanding at end of period | 555,938 | 11.01 | 0.4 | 555,938 | 11.01 | 0.4 |

As at September 30, 2010 and December 31, 2009, there was a total of $1.4 million and $0.9 million, respectively, of unrecognized compensation cost related to non-vested RSUs; that cost is expected to be recognized over a period of approximately 1.0 year and 1.0 year, respectively. A compensation expense of $0.2 million and $1.7 million, respectively, has been recorded in general and administrative expenses for the three and nine months ended September 30, 2010, compared to $0.5 million and $2.1 million, respectively, for the same periods in 2009 in relation to the RSU Plan.

Since the inception of the RSU Plan in July 2006, 400,842 RSUs granted to employees have vested and no RSUs granted to employees have been cancelled. During the three and nine months ended September 30, 2010, nil and 64,896 RSUs, respectively, were granted to the directors, compared to nil and 72,666 RSUs, respectively, during the same periods in 2009. During the three and nine months ended September 30, 2010, nil and 8,040 RSUs, respectively, granted to directors were converted into common shares of the Company as elected by the directors, compared to nil and 2,985 during the same periods in 2009.

The Company uses a nil forfeiture assumption for its PSUs and RSUs. The intrinsic value of the PSUs and RSUs outstanding as of September 30, 2010 was $41.9 million and $5.9 million, respectively.

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## 11. EARNINGS PER COMMON SHARE

The computation of basic and diluted earnings per common share for the three and nine months ended September 30, 2010 and 2009 is as follows:

| | For the three months ended September 30, | | For the nine months ended September 30, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| Basic earnings per common share | | | | |
| Net income attributable to Flagstone | $37,261 | $67,130 | $82,034 | $170,687 |
| Weighted average common shares outstanding | 77,369,143 | 83,799,627 | 79,605,828 | 84,505,115 |
| Weighted average vested restricted share units | 262,013 | 205,157 | 266,136 | 205,912 |
| Weighted average common shares outstanding—Basic | 77,631,156 | 84,004,784 | 79,871,964 | 84,711,027 |
| Basic earnings per common share | $0.48 | $0.80 | $1.03 | $2.01 |
| | | | | |
| Diluted earnings per common share | | | | |
| Net income attributable to Flagstone | $37,261 | $67,130 | $82,034 | $170,687 |
| Weighted average common shares outstanding | 77,369,143 | 83,799,627 | 79,605,828 | 84,505,115 |
| Weighted average vested restricted share units outstanding | 262,013 | 205,157 | 266,136 | 205,912 |
| | 77,631,156 | 84,004,784 | 79,871,964 | 84,711,027 |
| Share equivalents: | | | | |
| Weighted average unvested restricted share units | 141,691 | 171,818 | 199,195 | 198,313 |
| Weighted average common shares outstanding—Diluted | 77,772,847 | 84,176,602 | 80,071,159 | 84,909,340 |
| Diluted earnings per common share | $0.48 | $0.80 | $1.02 | $2.01 |

At September 30, 2010 and 2009, there was a warrant outstanding which would result in the issuance of 8,585,747 common shares that were excluded from the computation of diluted earnings per common share because the effect would be anti-dilutive. Because the number of shares contingently issuable under the PSU Plan depends on the average DROE over a two or three year period, the PSUs are excluded from the calculation of diluted earnings per common share until the end of the performance period, at which time the number of shares issuable under the PSU Plan will be known. As at September 30, 2010, and 2009, there were 3,945,058 and 2,813,585 PSUs expected to vest, respectively. The maximum number of common shares that could be issued under the PSU Plan at September 30, 2010 and 2009 was 5,179,372 and 4,220,378, respectively.

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## 12. COMMON SHARES

Common shares

At September 30, 2010, 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, 2009 – 300,000,000).

| | For the periods ended | |
|---|---|---|
| | September 30, 2010 | December 31, 2009 |
| Common voting shares: | | |
| Balance at beginning of period | 82,985,219 | 84,801,732 |
| Conversion of performance share units (1) | - | 42,000 |
| Conversion of restricted share units (1) | 8,040 | 141,487 |
| Shares repurchased and held in treasury | (6,405,106) | (2,000,000) |
| Balance at end of period | 76,588,153 | 82,985,219 |

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

Share buyback

On September 22, 2008, the Company announced that its Board of Directors had approved the repurchase of company common shares, subject to market conditions, share price and other factors. The buyback program allows the Company to purchase, from time to time, its outstanding stock up to a value of $60.0 million. As of December 31, 2009, approximately $33.6 million of repurchases remained available under the buyback program.

On March 11, 2010, the Company entered into a private purchase agreement to repurchase 2,984,146 common shares pursuant to its buyback program at a total cost of $33.6 million.

On May 18, 2010, the Company announced that its Board of Directors had approved an increase in its share buyback program allowing the Company to purchase, from time to time, subject to market conditions, share price and other factors, its outstanding common shares up to a value of $50.0 million.

On May 21, 2010, in connection with the resignation of Mark J. Byrne as Executive Chairman of the Company’s Board of Directors, the Company entered into a private purchase agreement, which was attached as Exhibit 10.2 to the Company’s Quarterly Report on Form 10-Q for the quarter ending June 30, 2010 filed with the SEC on August 3, 2010, for the repurchase of 2,000,000 common shares from Limestone Business Limited, a company controlled and capitalized by Mr. Byrne. These shares were repurchased pursuant to the Company’s buyback program on May 25, 2010, at a total cost of $24.0 million.

During the third quarter of 2010, the Company repurchased 1,420,960 common shares pursuant to its buyback program at a total cost of $14.8 million. Of the common shares repurchased, 900,000 common shares were purchased on August 20, 2010, under a private purchase agreement for the employee share compensation plans (PSU plan and RSU plan), while the remaining 520,960 common shares were purchased on the open market. As of September 30, 2010, authority to repurchase up to $11.2 million of common shares remained available under the buyback program.

## 13. LEGAL PROCEEDINGS

In the normal course of business, the Company may become involved in various claims litigation and legal proceedings. As at September 30, 2010, the Company was not a party to any material litigation or arbitration proceedings.

## 14. SEGMENT REPORTING

The Company reports its results to the chief operating decision maker based on three reportable segments: Reinsurance, Lloyd’s and Island Heritage (previously referred to as the Insurance segment until January 1, 2010). The Company regularly reviews its financial results and assesses its performance on the basis of these three reportable segments.

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The following tables provide a summary of gross and net written and earned premiums, underwriting results, a reconciliation of underwriting income to income before income taxes and interest in earnings of equity investments, total assets, and ratios for each reportable segment for the three and nine months ended September 30, 2010 and 2009:

| | For the three months ended September 30, 2010 | | | | |
|---|---|---|---|---|---|
| | Reinsurance | Lloyd's | Island Heritage | Inter-segment Eliminations (1) | Total |
| Gross premiums written | $ 129,701 | $ 35,567 | $ 29,479 | $ (9,098 ) | $ 185,649 |
| Premiums ceded | (13,565 ) | (4,812 ) | (16,994 ) | 9,098 | (26,273 ) |
| Net premiums written | 116,136 | 30,755 | 12,485 | - | 159,376 |
| Net premiums earned | $ 161,671 | $ 36,921 | $ 102 | $ - | $ 198,694 |
| Other related income | 295 | 845 | 5,677 | (4,408 ) | 2,409 |
| Loss and loss adjustment expenses | (95,780 ) | (23,466 ) | 157 | - | (119,089 ) |
| Acquisition costs | (21,949 ) | (8,961 ) | (4,113 ) | 4,408 | (30,615 ) |
| General and administrative expenses | (40,094 ) | (6,333 ) | (2,911 ) | - | (49,338 ) |
| Underwriting income (loss) | $ 4,143 | $ (994 ) | $ (1,088 ) | $ - | $ 2,061 |
| | | | | | |
| Loss ratio (2) | 59.2 % | 63.6 % | (2.7 )% | | 59.9 % |
| Acquisition cost ratio (2) | 13.6 % | 24.3 % | 71.2 % | | 15.4 % |
| General and administrative expense ratio (2) | 24.8 % | 17.2 % | 50.4 % | | 24.8 % |
| Combined ratio (2) | 97.6 % | 105.1 % | 118.9 % | | 100.1 % |
| Total assets | $ 2,536,580 | $ 259,362 | $ 101,531 | | $ 2,897,473 |
| | | | | | |
| Reconciliation: | | | | | |
| Underwriting income | | | | | $ 2,061 |
| Net investment income | | | | | 7,488 |
| Net realized and unrealized gains - investments | | | | | 40,165 |
| Net realized and unrealized gains - other | | | | | 7,677 |
| Other loss | | | | | (624 ) |
| Interest expense | | | | | (2,690 ) |
| | | | | | (17,072 ) |

| | |
|---|---|
| Net foreign exchange losses | |
| Income before income taxes and interest in earnings of equity investments | $ 37,005 |

| | For the three months ended September 30, 2009 | | | | |
|---|---|---|---|---|---|
| | Reinsurance | Lloyd's | Island Heritage | Inter-segment Eliminations (1) | Total |
| Gross premiums written | $ 132,274 | $ 24,356 | $ 28,215 | $ (10,255 ) | $174,590 |
| Premiums ceded | (24,168 ) | (10,243 ) | (15,621 ) | 10,251 | (39,781 ) |
| Net premiums written | 108,106 | 14,113 | 12,594 | (4 ) | 134,809 |
| Net premiums earned | $ 173,408 | $ 18,291 | $ 3,818 | $ - | $195,517 |
| Other related income | 1,037 | 1,454 | 4,127 | (2,956 ) | 3,662 |
| Loss and loss adjustment expenses | (69,134 ) | (11,012 ) | (29 ) | - | (80,175 ) |
| Acquisition costs | (29,972 ) | (4,648 ) | (3,560 ) | 2,956 | (35,224 ) |
| General and administrative expenses | (28,237 ) | (4,187 ) | (2,842 ) | - | (35,266 ) |
| Underwriting income (loss) | $ 47,102 | $ (102 ) | $ 1,514 | $ - | $48,514 |
| | | | | | |
| Loss ratio (2) | 39.9 % | 60.2 % | 0.4 % | | 41.0 % |
| Acquisition cost ratio (2) | 17.3 % | 25.4 % | 44.8 % | | 18.0 % |
| General and administrative expense ratio (2) | 16.3 % | 22.9 % | 35.8 % | | 18.0 % |
| Combined ratio (2) | 73.5 % | 108.5 % | 81.0 % | | 77.0 % |
| Total assets | $ 2,416,999 | $ 114,256 | $ 112,612 | | $2,643,867 |

| | |
|---|---|
| Reconciliation: | |
| Underwriting income | $48,514 |
| Net investment income | 10,779 |
| Net realized and unrealized gains - investments | 21,286 |
| Net realized and unrealized gains - other | 1,373 |
| Other income | 607 |
| Interest expense | (2,814 ) |
| Net foreign exchange losses | (2,390 ) |
| Income before income taxes and interest in earnings of equity investments | $77,355 |

(1) Inter-segment eliminations relate to Flagstone Suisse quota share arrangements with Island Heritage and Lloyd's.
(2) For Island Heritage segment all ratios calculated using expenses divided by net premiums earned plus other related income.

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| | For the nine months ended September 30, 2010 | | | | |
|---|---|---|---|---|---|
| | Reinsurance | Lloyd's | Island Heritage | Inter-segment Eliminations (1) | Total |
| Gross premiums written | $768,095 | $148,529 | $70,557 | $ (31,719) | $955,462 |
| Premiums ceded | (120,395) | (23,901) | (65,886) | 31,719 | (178,463) |
| Net premiums written | 647,700 | 124,628 | 4,671 | - | 776,999 |
| Net premiums earned | $532,296 | $110,219 | $5,073 | $ - | $647,588 |
| Other related income | 3,260 | 10,976 | 16,822 | (11,983) | 19,075 |
| Loss and loss adjustment expenses | (305,773) | (92,073) | (485) | - | (398,331) |
| Acquisition costs | (92,176) | (26,349) | (12,494) | 11,983 | (119,036) |
| General and administrative expenses | (108,199) | (17,890) | (7,146) | - | (133,235) |
| Underwriting income (loss) | $29,408 | $(15,117) | $1,770 | $ - | $16,061 |
| | | | | | |
| Loss ratio (2) | 57.4 % | 83.5 % | 2.2 % | | 61.5 % |
| Acquisition cost ratio (2) | 17.3 % | 23.9 % | 57.1 % | | 18.4 % |
| General and administrative expense ratio (2) | 20.3 % | 16.2 % | 32.6 % | | 20.6 % |
| Combined ratio (2) | 95.0 % | 123.6 % | 91.9 % | | 100.5 % |
| Total assets | $2,536,580 | $259,362 | $101,531 | | $2,897,473 |
| | | | | | |
| Reconciliation: | | | | | |
| Underwriting income | | | | | $16,061 |
| Net investment income | | | | | 22,992 |
| Net realized and unrealized gains - investments | | | | | 37,305 |
| Net realized and unrealized gains - other | | | | | 11,369 |
| Other income | | | | | 282 |
| Interest expense | | | | | (7,749) |
| Net foreign exchange losses | | | | | (5,260) |
| Income before income taxes and interest in earnings of equity investments | | | | | $75,000 |

| | For the nine months ended September 30, 2009 | | | | |
|---|---|---|---|---|---|
| | Reinsurance | Lloyd's | Island Heritage | Inter-segment Eliminations (1) | Total |

| | | | | | |
|---|---|---|---|---|---|
| Gross premiums written | $715,532 | $109,949 | $70,025 | $ (30,722) | $864,784 |
| Premiums ceded | (120,610) | (21,767) | (63,535) | 30,720 | (175,192) |
| Net premiums written | 594,922 | 88,182 | 6,490 | (2) | 689,592 |
| Net premiums earned | $512,139 | $38,495 | $4,694 | $ - | $555,328 |
| Other related income | 3,541 | 3,887 | 14,815 | (10,239) | 12,004 |
| Loss and loss adjustment expenses | (189,279) | (24,331) | (800) | - | (214,410) |
| Acquisition costs | (90,867) | (8,532) | (10,304) | 10,239 | (99,464) |
| General and administrative expenses | (85,129) | (11,484) | (7,531) | - | (104,144) |
| Underwriting income (loss) | $150,405 | $(1,965) | $874 | $ - | $149,314 |
| | | | | | |
| Loss ratio (2) | 37.0 % | 63.2 % | 4.1 % | | 38.6 % |
| Acquisition cost ratio (2) | 17.7 % | 22.2 % | 52.8 % | | 17.9 % |
| General and administrative expense ratio (2) | 16.6 % | 29.8 % | 38.6 % | | 18.8 % |
| Combined ratio (2) | 71.3 % | 115.2 % | 95.5 % | | 75.3 % |
| Total assets | $2,416,999 | $114,256 | $112,612 | | $2,643,867 |

| | |
|---|---|
| Reconciliation: | |
| Underwriting income | $149,314 |
| Net investment income | 19,672 |
| Net realized and unrealized gains - investments | 26,469 |
| Net realized and unrealized gains - other | 11,273 |
| Other loss | (233) |
| Interest expense | (9,490) |
| Net foreign exchange losses | (3,125) |
| Income before income taxes and interest in earnings of equity investments | $193,880 |

(1) Inter-segment eliminations relate to Flagstone Suisse quota share arrangements with Island Heritage and Lloyd's.
(2) For Island Heritage segment all ratios calculated using expenses divided by net premiums earned plus other related income.

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## 15. SUBSEQUENT EVENTS

The Company has evaluated subsequent events through the date the financial statements were available to be issued and has determined that there were no subsequent events that require disclosure.

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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 September 30, 2010 and December 31, 2009, and our results of operations for the three and nine months ended September 30, 2010 and 2009. 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, 2009 (our "Annual Report"), filed with the SEC on March 1, 2010. Some of the information contained in this discussion and analysis is included elsewhere in this document, including information with respect to our plans and strategy for our business, and includes forward-looking statements that involve risks and uncertainties. Please see the "Cautionary Statement Regarding Forward-Looking Statements" for more information. You should review Item 1A, "Risk Factors" contained in the 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 on Form 10-Q to the "Company", "Flagstone", "we", "us", and "our" refer to Flagsto Reinsurance Holdings, S.A. and/or its subsidiaries, including Flagstone Réassurance Suisse SA, its wholly-owned Switzerland reinsurance company, Flagstone Syndicate Management Limited (formerly Marlborough Underwriting Agency Limited), its United Kingdom Lloyd's managing agency, Island Heritage Holdings Ltd., its Cayman Islands based insurance holding company, Flagstone Reinsurance Africa Limited, its South African reinsurance company, Mont Fort Re Ltd., its wholly-owned Bermuda reinsurance company, and any other direct or indirect wholly-owned subsidiary, unless the context suggests otherwise. References to "Flagstone Suisse" refer to Flagstone Réassurance Suisse SA, 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 Alliance" refer to Flagstone Alliance Insurance & Reinsurance PLC 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, 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 United States of America or whose primary transactions are in foreign currency.

## Executive Overview

We are a global reinsurance and insurance company. Our management views us as being organized into three reporting segments: Reinsurance, Lloyd's and Island Heritage (previously referred to as our Insurance segment). Through our Reinsurance segment, we write primarily property, property catastrophe and short-tail specialty and casualty insurance and reinsurance. Through our Lloyd's segment, we write primarily property and short-tail specialty and casualty insurance and reinsurance focused on the energy, hull and cargo, marine liability, engineering and aviation business sectors. Through our Island Heritage segment, we primarily write property insurance for homes, condominiums and office buildings in the Caribbean region.

Our financial statements are prepared in accordance with U.S. GAAP and our fiscal year ends on December 31. Since a substantial portion of the reinsurance we write provides protection from damages relating to natural and man-made catastrophes, our results depend to a large extent on the frequency and severity of such catastrophic events, and the specific insurance coverages we offer to clients affected by these events. This may result in volatility in our results of operations and financial condition. In addition, the amount of premiums written with respect to any particular line of business may vary from quarter to quarter and year to year as a result of changes in market conditions.

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

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We derive our revenues primarily from net premiums earned from the reinsurance and insurance policies we write, net of any retrocessional or reinsurance coverage purchased, net investment income from our investment portfolio, and fees for services provided.  Premiums are generally a function of the number and type of contracts we write, as well as prevailing market prices. Premiums are normally due in installments and earned over the contract term, which ordinarily is 12 or 24 months.

Our expenses consist primarily of the following types: loss and loss adjustment expenses ("LAE") incurred on the policies of reinsurance and insurance that we sell; acquisition costs which typically represent a percentage of the premiums that we write and can include brokerage, gross commission costs, profit commission and premium taxes; general and administrative expenses which primarily consist of salaries, benefits and related costs, including costs associated with awards under our PSU and RSU Plans, and other general operating expenses; interest expenses related to our debt obligations; and noncontrolling interest, which represents the interest of external parties with respect to the net income of Mont Fort, Island Heritage, and Flagstone Africa (until November 10, 2009).  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.  Effective May 17, 2010, we became a Luxembourg tax resident entity due to the redomestication (discussed below) and therefore will be subject to Luxembourg corporate income tax, municipal business tax, withholding tax, and net wealth tax. Our management will attempt to minimize the income tax impact through effective tax planning.

On March 22, 2010, we announced that our Board of Directors recommended a proposal for a redomestication to change our jurisdiction of incorporation from Bermuda to Luxembourg.  On May 14, 2010, our shareholders approved the redomestication and we thereby discontinued our existence as a Bermuda company as provided in Section 132G of the Companies Act 1981 of Bermuda and continued our existence as a société anonyme under the laws of Luxembourg effective May 17, 2010.  We do not expect the redomestication to have a material impact on the way we operate or on our financial condition or results of operations.

On May 21, 2010, Mark J. Byrne stepped down as Executive Chairman of our Board of Directors.  In connection with his resignation, Flagstone Holdings (Bermuda) Limited ("Bermuda Holdings"), one of our subsidiaries, and Mr. Byrne entered into a General Release and Settlement Agreement (the "Release Agreement") which was filed as Exhibit 10.1 to our Quarterly Report for the quarter ending June 30, 2010 filed with the SEC on August 3, 2010.  Mr. Byrne continues to serve as a non-executive member of our Board of Directors.  David Brown, who has served as our Chief Executive Officer since our inception in 2005 and all other members of the senior management team, continue in their current roles.  Daniel James, a member of the Board of Directors since our inception, has succeeded Mr. Byrne as Chairman.

We report our results to the chief operating decision maker based on three reportable segments:  Reinsurance, Lloyd's and Island Heritage.  We regularly review our financial results and assess our performance on the basis of these three reportable 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.

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(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. 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.

Lloyd's

Our Lloyd's segment includes the business generated through the Lloyd's Syndicate 1861 and FSML. Syndicate 1861 primarily provides property and short-tail specialty and casualty insurance and reinsurance for risks such as energy, hull and cargo, marine liability, engineering and aviation. FSML generates fee income from the provision of services to syndicates and third parties.

Island Heritage

Island Heritage is a property and casualty insurer based in the Cayman Islands which is primarily in the business of insuring homes, condominiums and office buildings in the Caribbean region.

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 Annual Report. Our critical accounting policies at September 30, 2010, have not changed compared to December 31, 2009.

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 in Item 1A, "Risk Factors," of the 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.

New Accounting Pronouncements

Adoption of new accounting pronouncements

During the first quarter of 2010, we adopted the FASB amendments to ASC Topic 860, "Transfers and Servicing," ("ASC 860") which codified FASB Statement No. 166, "Accounting for Transfers of Financial Assets". ASC 860 requires that a transferor recognize and initially measure at fair value all assets obtained (including a transferor's beneficial interest) and liabilities incurred as a result of financial assets accounted for as a sale. It is a revision to FASB

Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," and requires more information about transfers of financial assets, including securitization transactions, and where entities have continuing exposure to the risks related to transferred financial assets. The effect of adopting ASC 860 did not have a material impact on our consolidated results of operations and financial condition.

During the first quarter of 2010, we adopted the amendments to the FASB ASC Topic 810, "Consolidation" ("ASC 810") which codified FASB Statement No. 167, "Amendments to FASB Interpretation No. 46(R)". ASC 810 amends FASB Statement No. 46 (revised December 2003), "Consolidation of Variable Interest Entities", to require an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. It prescribes determination of whether a reporting entity is required to consolidate another entity based on, among other things, the other entity's purpose and design and the reporting entity's ability to direct the activities of the other entity that most significantly impact the other entity's economic performance. The effect of adopting the amendments to ASC 810 did not have a material impact on our consolidated results of operations and financial condition.

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In January 2010, the FASB issued Accounting Standards Update No. 2010-06, “Fair Value Measurements and Disclosures (Topic 820) - Improving Disclosures about Fair Value Measurements” (“ASU 2010-06”). This update requires new disclosures about fair value measurement as set forth in the Fair Value Measurements and Disclosures – Overall Subtopic of the FASB ASC. Specifically, this update requires disclosing (1) the amounts of significant transfers in and out of Level 1 and 2 fair value measurements and the reasons for the transfers, and (2) information about purchases, sales, issuances, and settlements separately in the reconciliation for fair value measurements using significant unobservable inputs. The ASU 2010-06 was effective for interim and annual periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. We adopted the relevant portions of ASU 2010-06 in the first quarter of 2010, and the effect of adopting the update did not have a material impact on the consolidated results of operations and financial condition.

New accounting pronouncements

In October 2010, the FASB issued Accounting Standards Update No. 2010-26, “Financial Services and Insurance (Topic 944) – Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts” (“ASU 2010-26”). The objective of ASU 2010-26 is to address diversity in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. ASU 2010-26 is effective for interim and annual periods beginning after December 15, 2011. We are currently assessing the potential impact, if any, of the adoption of ASU 2010-26 on our consolidated results of operations and financial condition.

Results of Operations - For the Three and Nine Months Ended September 30, 2010 and 2009

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 Annual Report for a discussion on translation of foreign currencies.

| U.S. dollar (weakened) strengthened against: | For the three months ended September 30, 2010 | For the nine months ended September 30, 2010 |
|---|---|---|
| Canadian dollar | (3.5)% | (1.9)% |
| Swiss franc | (9.7)% | (5.2)% |
| Euro | (11.5)% | 5.0% |
| British pound sterling | (5.1)% | 2.7% |
| Indian rupee | (3.4)% | (3.6)% |
| South African rand | (10.1)% | (5.6)% |

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Summary Overview

The following table sets forth financial highlights for the three months ending September 30, 2010 and 2009:

| | For the three months ended September 30, 2010 | 2009 | $ Change | % Change |
|---|---|---|---|---|
| Underwriting income | $ 2,061 | $ 48,514 | $ (46,453 ) | (95.8 )% |
| Net investment income | $ 7,488 | $ 10,779 | $ (3,291 ) | (30.5 )% |
| Net realized and unrealized gains - investments | $ 40,165 | $ 21,286 | $ 18,879 | 88.7 % |
| Net realized and unrealized gains - other | $ 7,677 | $ 1,373 | $ 6,304 | 459.1 % |
| Net income attributable to Flagstone | $ 37,261 | $ 67,130 | $ (29,869 ) | (44.5 )% |
| | | | | |
| Net income attributable to Flagstone per common share—Basic | $ 0.48 | $ 0.80 | $ (0.32 ) | |
| Net income attributable to Flagstone per common share—Diluted (1) | $ 0.48 | $ 0.80 | $ (0.32 ) | |
| Loss ratio | 59.9 % | 41.0 % | | 18.9 % |
| Expense ratio | 40.2 % | 36.0 % | | 4.2 % |
| Combined ratio | 100.1 % | 77.0 % | | 23.1 % |

| | As at September 30, 2010 | December 31, 2009 | $ Change | % Change |
|---|---|---|---|---|
| Basic book value per common share | $ 15.93 | $ 14.56 | $ 1.37 | 9.4 % |
| Diluted book value per common share | $ 15.10 | $ 13.97 | $ 1.13 | 8.1 % |
| Diluted book value per common share plus accumulated distributions (2) | $ 15.62 | $ 14.36 | $ 1.26 | 8.8 % |

The following table sets forth financial highlights for the nine months ending September 30, 2010 and 2009:

| | For the nine months ended September 30, 2010 | 2009 | $ Change | % Change |
|---|---|---|---|---|
| Underwriting income | $ 16,061 | $ 149,314 | $ (133,253 ) | (89.2 )% |
| Net investment income | $ 22,992 | $ 19,672 | $ 3,320 | 16.9 % |
| Net realized and unrealized gains - investments | $ 37,305 | $ 26,469 | $ 10,836 | 40.9 % |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Net realized and unrealized gains - other | $ | 11,369 | | $ | 11,273 | | $ | 96 | | 0.9 | % |
| Net income attributable to Flagstone | $ | 82,034 | | $ | 170,687 | | $ | (88,653 | ) | (51.9 | )% |
| | | | | | | | | | | | |
| Net income attributable to Flagstone per common share—Basic | $ | 1.03 | | $ | 2.01 | | $ | (0.98 | ) | | |
| Net income attributable to Flagstone per common share—Diluted (1) | $ | 1.02 | | $ | 2.01 | | $ | (0.99 | ) | | |
| Loss ratio | | 61.5 | % | | 38.6 | % | | | | 22.9 | % |
| Expense ratio | | 39.0 | % | | 36.7 | % | | | | 2.3 | % |
| Combined ratio | | 100.5 | % | | 75.3 | % | | | | 25.2 | % |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | As at | | | | | |
| | | September 30, 2010 | | December 31, 2009 | | $ Change | | % Change | |
| Basic book value per common share | $ | 15.93 | $ | 14.56 | $ | 1.37 | | 9.4 | % |
| Diluted book value per common share | $ | 15.10 | $ | 13.97 | $ | 1.13 | | 8.1 | % |
| Diluted book value per common share plus accumulated distributions (2) | $ | 15.62 | $ | 14.36 | $ | 1.26 | | 8.8 | % |

(1) Net income attributable to Flagstone per common share - Diluted for the three and nine months ended September 30, 2010, does not contain the effect of:

a. the warrant conversion as this would be anti-dilutive for U.S. GAAP purposes.

b. 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 3,945,058 PSU's expected to vest under the PSU plan as at September 30, 2010.

(2) Distributions paid per common share are in the form of a non-dividend return of capital. Prior to the Company's redomestication to Luxembourg on May 17, 2010, such distributions were in the form of dividends.

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The decrease in underwriting income in the three and nine months ended September 30, 2010, is primarily due to significant catastrophe losses (net of reinsurance and reinstatements) in those periods compared to the same periods last year. The three main events in the nine month periods ended September 30, 2010, are the Chile earthquake ($59.8 million; Reinsurance segment - $53.5 million, Lloyd's segment $6.3 million), which occurred in the first quarter, the Deepwater Horizon oil rig explosion ($41.3 million; Reinsurance segment - $27.3 million, Lloyd's segment $14.0 million), which occurred in the second quarter and the New Zealand earthquake ($52.5 million; Reinsurance segment - $51.2 million, Lloyd's segment $1.3 million) which occurred during the third quarter.  As described in the year to date reinsurance segment discussion below, $22.9 million of loss expenses during the second quarter relate to losses incurred by Mont Fort. Although such loss expenses are consolidated within our results, they do not impact Flagstone's net income as they are attributable to the noncontrolling interest.  The increases in the net realized and unrealized gains on investments for the three and nine months ended September 30, 2010, were primarily due to realized and unrealized gains on the fixed maturities due to tightening of credit spreads and decrease in interest rates.

The following table provides supplemental financial data regarding the net impact from the second quarter losses on the Deepwater Horizon oil rig on our reporting segments' financial results for the nine months ended September 30, 2010:

| | For the nine months ended September 30, 2010 ($ in millions) | | | |
|---|---|---|---|---|
| | Reinsurance | Lloyd's | Island Heritage | Total |
| Gross losses incurred | $(27.5) | $(18.2) | - | $(45.7) |
| Losses retroceded excluding Mont Fort sidecar | 0.2 | 0.9 | - | 1.1 |
| Reinstatement premiums earned | - | 3.3 | - | 3.3 |
| Net impact on segment results | (27.3) | (14.0) | - | (41.3) |
| | | | | |
| Noncontrolling interest - Mont Fort sidecar | 22.9 | - | - | 22.9 |
| | | | | |
| Consolidated net income impact | $(4.4) | $(14.0) | $- | $(18.4) |

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

In addition to the U.S. GAAP financial measures set forth in this Quarterly Report, we have presented "basic and diluted book value per common share, which is a non-GAAP financial measure.  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 restricted share units, 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 the warrant, PSU and RSU. 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 September 30, 2010 and 2009.

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Non-GAAP Reconciliation

| | | As at September 30, 2010 | | As at December 31, 2009 |
|---|---|---|---|---|
| | (Expressed in thousands of U.S. dollars, except share and per share data) | | | |
| Flagstone shareholders' equity | $ | 1,224,053 | $ | 1,211,018 |
| Potential net proceeds from assumed: | | | | |
| Exercise of PSU (1) | | - | | - |
| Exercise of RSU (1) | | - | | - |
| Conversion of warrant (2) | | - | | - |
| Diluted Flagstone shareholders' equity | $ | 1,224,053 | $ | 1,211,018 |
| | | | | |
| Cumulative distributions paid per outstanding common share (3) | $ | 0.52 | $ | 0.40 |
| | | | | |
| Common shares outstanding - end of period | | 76,588,153 | | 82,985,219 |
| Vested RSUs | | 262,013 | | 205,157 |
| Total common shares outstanding - end of period | | 76,850,166 | | 83,190,376 |
| | | | | |
| Potential shares to be issued: | | | | |
| PSUs expected to vest | | 3,945,058 | | 3,305,713 |
| RSUs outstanding | | 293,925 | | 168,000 |
| Conversion of warrant (2) | | - | | - |
| Common shares outstanding - diluted | | 81,089,149 | | 86,664,089 |
| | | | | |
| Basic book value per common share | $ | 15.93 | $ | 14.56 |
| | | | | |
| Diluted book value per common share | $ | 15.10 | $ | 13.97 |
| | | | | |
| Basic book value per common share plus accumulated distributions | $ | 16.45 | $ | 14.96 |
| | | | | |
| Diluted book value per common share plus accumulated distributions | $ | 15.62 | $ | 14.36 |
| | | | | |
| Distributions per common share paid during the period (3) | $ | 0.12 | | |

(1) No proceeds due when exercised
(2) Below strike price - not dilutive
(3) Distributions paid per common share are in the form of a non-dividend return of capital. Prior to the Company's redomestication to Luxembourg on May 17, 2010, such distributions were in the form of dividends

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Outlook and Trends

North America

As anticipated, demand for North American catastrophe reinsurance was met by available reinsurance market capacity resulting in orderly but softening renewals continuing through the third quarter 2010. On average, approximately 10% price reductions were observed on the third quarter business which was heavily dominated by July 1 Atlantic hurricane exposed renewals. A high level of hurricane activity was experienced with hurricanes Earl and Igor threatening but fortunately not making a direct US landfall; producing no material U.S. insured losses. This has resulted in significant profits for reinsurers writing US Cat reinsurance business through the end of October. Overall, barring any significant industry losses to harden the market, we expect a general a softening trend to continue into 2011, marked by increased discipline from reinsurers exercising increasing amounts of share buybacks.

Specialty Lines

Global Specialty lines continue to be mixed, with some lines offering attractive risk-adjusted pricing while conversely some areas remain under pressure. Softening rates in the energy sector should be reversed, particularly marine liabilities as a result of the Deepwater Horizon loss and expected increasing demand. Unfortunately this market has not hardened to the degree initially expected through the third quarter. Both commercial aviation and workers compensation catastrophe lines of business continue to provide inadequate returns for the associated risk in our view. However, we approach the specialty lines tactically, and continue to search for attractive transactions that help achieve the highest risk adjusted margins.

International

Price easing has continued during the third quarter but in a controlled manner with the Reinsurance market maintaining a disciplined approach. Latin America and Australia dominated the July 1 renewals and pricing was generally flat to off 5%, with the exception of programs that had sustained losses from the Chile earthquake or hail storms in Australia, where rate increases were evident. The expectation is for continued softening, although the recent October 1 renewals indicated that any price reduction will hopefully be kept to a modest level between 0% to 5%.

Underwriting Results by Segment

We are organized into three reportable segments: Reinsurance, Lloyd’s and Island Heritage. Our Reinsurance segment provides reinsurance through our property, property catastrophe and short-tail specialty and casualty reinsurance business units. Our Lloyd’s segment primarily provides property and short-tail specialty and casualty insurance and reinsurance for risks such as energy, hull and cargo, marine liability, engineering and aviation. Our Island Heritage segment includes insurance business generated through Island Heritage, a property insurer based in the Cayman Islands which is primarily in the business of insuring homes, condominiums and office buildings in the Caribbean region.

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Gross Premiums Written

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

| | For the three months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | | 2009 | |
| | Gross premiums written | Percentage of total | Gross premiums written (5) | Percentage of total |
| Line of business | | | | |
| Reinsurance and Lloyd's (1) | | | | |
| Property catastrophe | $ 54,075 | 29.1 % | $ 60,281 | 34.5 % |
| Property | 52,011 | 28.0 % | 43,310 | 24.8 % |
| Short-tail specialty and casualty | 50,084 | 27.0 % | 42,784 | 24.5 % |
| Island Heritage Insurance | 29,479 | 15.9 % | 28,215 | 16.2 % |
| Total | $ 185,649 | 100.0 % | $ 174,590 | 100.0 % |

| | For the nine months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | | 2009 | |
| | Gross premiums written | Percentage of total | Gross premiums written (5) | Percentage of total |
| Line of business | | | | |
| Reinsurance and Lloyd's (1) | | | | |
| Property catastrophe | $ 454,071 | 47.5 % | $ 443,332 | 51.3 % |
| Property | 210,580 | 22.0 % | 151,813 | 17.5 % |
| Short-tail specialty and casualty | 220,254 | 23.1 % | 199,614 | 23.1 % |
| Island Heritage Insurance | 70,557 | 7.4 % | 70,025 | 8.1 % |
| Total | $ 955,462 | 100.0 % | $ 864,784 | 100.0 % |

| | For the three months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | | 2009 | |
| | Gross premiums written | Percentage of total | Gross premiums written (5) | Percentage of total |
| Geographic area of risk insured (2) | | | | |
| Caribbean (3) | $ 33,444 | 18.0 % | $ 29,252 | 16.8 % |
| Europe | 14,083 | 7.6 % | 17,303 | 9.9 % |
| Japan and Australasia | 11,799 | 6.4 % | 17,181 | 9.8 % |
| North America | 68,181 | 36.7 % | 53,137 | 30.4 % |
| Worldwide risks (4) | 33,114 | 17.8 % | 39,714 | 22.8 % |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Other | | 25,028 | 13.5 | % | | 18,003 | 10.3 | % |
| Total | $ | 185,649 | 100.0 | % | $ | 174,590 | 100.0 | % |

| | For the nine months ended September 30, | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2010 | | | | 2009 | | | |
| | Gross premiums written | | Percentage of total | | Gross premiums written (5) | | Percentage of total | |
| Geographic area of risk insured (2) | | | | | | | | |
| Caribbean (3) | $ | 83,218 | 8.7 | % | $ | 78,041 | 9.0 | % |
| Europe | | 112,778 | 11.8 | % | | 102,735 | 11.9 | % |
| Japan and Australasia | | 57,301 | 6.0 | % | | 55,564 | 6.4 | % |
| North America | | 421,701 | 44.2 | % | | 370,888 | 42.9 | % |
| Worldwide risks (4) | | 212,434 | 22.2 | % | | 201,910 | 23.4 | % |
| Other | | 68,030 | 7.1 | % | | 55,646 | 6.4 | % |
| Total | $ | 955,462 | 100.0 | % | $ | 864,784 | 100.0 | % |

(1) Gross premiums written relating to Lloyd’s segment are primarily included in property and short-tail specialty and casualty.

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

(3) Gross premiums written related to the Island Heritage segment are included in the Caribbean geographic area.

(4) This geographic area includes contracts that cover risks in two or more geographic zones.

(5) Gross premiums written in 2009 have been reclassified to conform to current year presentation.

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Reinsurance Segment

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 and the nature of our gross premiums written during a particular period.

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. The majority of these contracts are excess-of-loss contracts covering one or more lines of business. To a lesser extent we have also purchased quota share reinsurance with respect to specific lines of business. We also purchase protection through catastrophe bond structures, Valais Re and 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.

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

Below is a summary of the underwriting results and ratios for our Reinsurance segment for the three months ended September 30, 2010 and 2009:

| | For the three months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | 2009 | $ Change | % Change |
| Property catastrophe reinsurance | $ 63,162 | $ 69,715 | $ (6,553) | (9.4)% |
| Property reinsurance | 35,888 | 31,689 | 4,199 | 13.3 % |
| Short tail specialty and casualty reinsurance | 30,651 | 30,870 | (219) | (0.7)% |
| Gross premiums written | 129,701 | 132,274 | (2,573) | (1.9)% |
| Premiums ceded | (13,565) | (24,168) | 10,603 | (43.9)% |
| Net premiums written | 116,136 | 108,106 | 8,030 | 7.4 % |
| Net premiums earned | 161,671 | 173,408 | (11,737) | (6.8)% |
| Other related income | 295 | 1,037 | (742) | (71.5)% |
| Loss and loss adjustment expenses | (95,780) | (69,134) | (26,646) | 38.5 % |
| Acquisition costs | (21,949) | (29,972) | 8,023 | (26.8)% |
| General and administrative expenses | (40,094) | (28,237) | (11,857) | 42.0 % |
| Underwriting income | $ 4,143 | $ 47,102 | $ (42,959) | (91.2)% |
| | | | | |
| Loss ratio | 59.2 % | 39.9 % | | 19.3 % |
| Acquisition cost ratio | 13.6 % | 17.3 % | | (3.7)% |
| General and administrative expense ratio | 24.8 % | 16.3 % | | 8.5 % |
| Combined ratio | 97.6 % | 73.5 % | | 24.1 % |

- The decrease in net underwriting results is primarily related to incurred losses on more significant catastrophic events in 2010, such as New Zealand earthquake, as compared to the same period in 2009, and to the increase in general and administrative expenses which is related to asset impairment losses.

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- Premiums ceded were 10.5% of gross reinsurance premiums written compared to 18.3% for the same period in 2009.

- Each quarter we review our premiums estimates and commission accruals based on information provided by brokers and clients. For proportional treaties, gross premiums written and related acquisition costs are estimated on a quarterly basis based on discussions with ceding companies, together with historical experience and management's judgment. During the quarter ended September 30, 2010, we recorded negative premiums adjustments on large proportional treaties. As a result, gross premiums written, net premiums earned and acquisition costs decreased for the quarter ended September 30, 2010.

- The increase in the loss ratio compared to the third quarter of 2009 was primarily due to more significant losses from catastrophic events in the current quarter compared to the same period last year, including net incurred losses related to the New Zealand earthquake ($51.2 million).

- Each quarter we revisit our loss estimates for previous loss events. During the quarter ended September 30, 2010, based on updated estimates provided by clients and brokers, we recorded net adverse developments for prior accident years of $3.7 million. During the third quarter of 2009, the net favorable developments for prior catastrophe events were $0.4 million.

- The increase in general and administrative expenses is mainly attributable to charges of $12.9 million related to our decision to sell corporate aircraft ($11.6 million of impairment charge related to assets held for sale and $1.3 million loss on sale). See Note 7 "Assets Held for Sale" to the unaudited condensed consolidated financial statements for further details regarding the impairment charge.

Below is a summary of the underwriting results and ratios for our Reinsurance segment for the nine months ended September 30, 2010 and 2009:

| | For the nine months ended September 30, 2010 | 2009 | $ Change | % Change |
|---|---|---|---|---|
| Property catastrophe reinsurance | $479,660 | $470,281 | $9,379 | 2.0 % |
| Property reinsurance | 144,162 | 118,692 | 25,470 | 21.5 % |
| Short tail specialty and casualty reinsurance | 144,273 | 126,559 | 17,714 | 14.0 % |
| Gross premiums written | 768,095 | 715,532 | 52,563 | 7.3 % |
| Premiums ceded | (120,395) | (120,610) | 215 | (0.2)% |
| Net premiums written | 647,700 | 594,922 | 52,778 | 8.9 % |
| Net premiums earned | 532,296 | 512,139 | 20,157 | 3.9 % |
| Other related income | 3,260 | 3,541 | (281) | (7.9)% |
| Loss and loss adjustment expenses | (305,773) | (189,279) | (116,494) | 61.5 % |
| Acquisition costs | (92,176) | (90,867) | (1,309) | 1.4 % |
| General and administrative expenses | (108,199) | (85,129) | (23,070) | 27.1 % |
| Underwriting income | $29,408 | $150,405 | $(120,997) | (80.4)% |
| | | | | |
| Loss ratio | 57.4 % | 37.0 % | | 20.4 % |

| | | | | | | |
|---|---|---|---|---|---|---|
| Acquisition cost ratio | 17.3 | % | 17.7 | % | (0.4 | )% |
| General and administrative expense ratio | 20.3 | % | 16.6 | % | 3.7 | % |
| Combined ratio | 95.0 | % | 71.3 | % | 23.7 | % |

- The decrease in net underwriting results is primarily related to incurred losses on more significant catastrophic events in 2010, such as the New Zealand earthquake, which occurred in the third quarter, Deepwater Horizon loss discussed above, which occurred in the second quarter and the net losses on the first quarter Chile earthquake, as compared to the same period in 2009, as well as a significant increase in general and administrative expenses. The increase in general and administrative expenses is discussed in more detail below.

- The increase in gross property reinsurance premiums written is primarily due to increased signed share with existing clients and the addition of new clients, also the increase in gross short tail specialty and casualty reinsurance premiums written are primarily driven by increased business with existing clients and the addition of new clients.

- Premiums ceded were 15.7% of gross reinsurance premiums written compared to 16.9% for the same period in 2009.

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- The increase in the loss ratio compared to the same period in 2009 was primarily due to more significant losses from catastrophic events in the current period compared to the same period last year, including net incurred losses related to the New Zealand earthquake ($51.2 million), the Chile earthquake ($59.4 million) and to Deepwater Horizon oil rig ($27.3 million). The Deepwater Horizon loss is driven by an ILW loss of $25.0 million, approximately 91.0% of which is attributable to Mont Fort. While such loss expenses are consolidated within our results, they do not impact Flagstone's net income as they are attributable to the noncontrolling interest. The loss (net of recoveries and reinstatement premiums) to Flagstone's reinsurance segment from the Deepwater Horizon rig was $4.4 million.

- The increase in general and administrative expenses is mainly attributable to charges of $12.9 million related to our decision to sell corporate aircraft ($11.6 million of impairment charge related to assets held for sale and $1.3 million loss on sale), a $2.2 million severance expense related to the resignation of our Executive Chairman, an impairment charge of $1.1 million for intangible assets and to higher stock compensation costs compared to the same period in 2009. See Note 6 "Goodwill and Intangibles" and Note 7 "Assets Held for Sale" to the unaudited condensed consolidated financial statements for further details regarding the impairment charges.

Lloyd's Segment

Overview

As a result of the acquisition of FSML, the managing agency for Lloyd's Syndicate 1861, in November 2008, we established a new reporting segment. Syndicate 1861 began writing business for the benefit of Flagstone effective January 1, 2009. Due to the start up nature of the 2009 year of account for Syndicate 1861, the level of earned premium income is gradually ramping up with new business writings, placing strain on the underwriting results as we have incurred expenses for the full periods.

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 and the nature of our gross premiums written during a particular period.

Below is a summary of the underwriting results and ratios for our Lloyd's segment for the three months ended September 30, 2010 and 2009:

| | For the three months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | 2009 | $ Change | % Change |
| Property reinsurance | $16,123 | $11,621 | $4,502 | 38.7 % |
| Short tail specialty and casualty reinsurance | 19,444 | 12,735 | 6,709 | 52.7 % |
| Gross premiums written | 35,567 | 24,356 | 11,211 | 46.0 % |
| Premiums ceded | (4,812) | (10,243) | 5,431 | (53.0)% |
| Net premiums written | 30,755 | 14,113 | 16,642 | 117.9 % |
| Net premiums earned | 36,921 | 18,291 | 18,630 | 101.9 % |
| Other related income | 845 | 1,454 | (609) | (41.9)% |
| Loss and loss adjustment expenses | (23,466) | (11,012) | (12,454) | 113.1 % |

| | | | | |
|---|---|---|---|---|
| Acquisition costs | (8,961) | (4,648) | (4,313) | 92.8% |
| General and administrative expenses | (6,333) | (4,187) | (2,146) | 51.3% |
| Underwriting loss | $(994) | $(102) | $(892) | (874.5)% |
| | | | | |
| Loss ratio | 63.6% | 60.2% | | 3.4% |
| Acquisition cost ratio | 24.3% | 25.4% | | (1.1)% |
| General and administrative expense ratio | 17.2% | 22.9% | | (5.7)% |
| Combined ratio | 105.1% | 108.5% | | (3.4)% |

- The increase in the gross property premiums written is primarily due to the growth in direct and facultative and binder business, while the growth in gross specialty premiums written is primarily due to growth in hull and energy business.

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- Premiums ceded were 13.5% of gross premiums written compared to 42.1% of gross premiums written for the same quarter in 2009.

- Premiums ceded to Flagstone Suisse under our intercompany reinsurance programs were less than $0.1 million compared to $0.8 million for the same quarter in 2009. This amount is eliminated upon consolidation.

- The loss expenses for the three months ended September 30, 2010 have increased due to the growth in the business.

- The decrease in acquisition cost ratio is primarily attributable to changes in the business mix. Acquisition costs include brokerage, gross commission costs, profit commission and premium taxes. The acquisition cost ratio is calculated by dividing acquisition cost expenses by net premiums earned.

- General and administrative expenses include staff and salary related costs, administration expenses and Lloyd's specific costs such as syndicate expenses. The increase in the third quarter of 2010, as compared to the same period in 2009, is primarily related to the growth in our Lloyd's operations and an impairment charge of $1.2 million for intangible assets. See Note 6 "Goodwill and Intangibles" to the unaudited condensed consolidated financial statements for further details regarding the impairment charge.

Below is a summary of the underwriting results and ratios for our Lloyd's segment for the nine months ended September 30, 2010 and 2009:

| | For the nine months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | 2009 | $ Change | % Change |
| Property reinsurance | $ 66,413 | $ 39,060 | $ 27,353 | 70.0 % |
| Short tail specialty and casualty reinsurance | 82,116 | 70,889 | 11,227 | 15.8 % |
| Gross premiums written | 148,529 | 109,949 | 38,580 | 35.1 % |
| Premiums ceded | (23,901 ) | (21,767 ) | (2,134 ) | 9.8 % |
| Net premiums written | 124,628 | 88,182 | 36,446 | 41.3 % |
| Net premiums earned | 110,219 | 38,495 | 71,724 | 186.3 % |
| Other related income | 10,976 | 3,887 | 7,089 | 182.4 % |
| Loss and loss adjustment expenses | (92,073 ) | (24,331 ) | (67,742 ) | 278.4 % |
| Acquisition costs | (26,349 ) | (8,532 ) | (17,817 ) | 208.8 % |
| General and administrative expenses | (17,890 ) | (11,484 ) | (6,406 ) | 55.8 % |
| Underwriting (loss) | $ (15,117 ) | $ (1,965 ) | $ (13,152 ) | (669.3 )% |
| | | | | |
| Loss ratio | 83.5 % | 63.2 % | | 20.3 % |
| Acquisition cost ratio | 23.9 % | 22.2 % | | 1.7 % |
| General and administrative expense ratio | 16.2 % | 29.8 % | | (13.6 )% |
| Combined ratio | 123.6 % | 115.2 % | | 8.4 % |

- The increase in the gross property premiums written is primarily due to the growth in direct and facultative and binder business.

- Premiums ceded were 16.1% of gross premiums written compared to 19.8% of gross premiums written for the same period in 2009.

- Premiums ceded to Flagstone Suisse under our intercompany reinsurance programs were $6.1 million compared to $3.8 million for the same period in 2009. The 2009 intercompany reinsurance program began during the second quarter. This amount is eliminated upon consolidation.

- Other related income, derived from services provided to syndicates and third parties, increased primarily as a result of the recognition of profit commission from Syndicate 1861's 2007 year of account, recorded in the first quarter in the amount of $7.0 million.

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- Loss events recorded include:

  - Second quarter 2010 - loss of $17.3 million related to the Deepwater Horizon oil rig ($14.0 million net of reinstatement premiums), and
  - First quarter 2010 - loss of $6.6 million related to the Chile earthquake ($6.3 million net of reinstatement premiums).

- General and administrative expenses include staff and salary related costs, administration expenses and Lloyd's specific costs such as syndicate expenses. The increase is primarily related to the growth in Lloyd's operations and an impairment charge of $1.2 million for intangible assets. See Note 6 "Goodwill and Intangibles" to the unaudited condensed consolidated financial statements for further details regarding the impairment charge.

Island Heritage Segment

Below is a summary of the underwriting results and ratios for our Island Heritage segment for the three months ended September 30, 2010 and 2009:

| | For the three months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | 2009 | $ Change | % Change |
| Gross premiums written | $ 29,479 | $ 28,215 | $ 1,264 | 4.5 % |
| Premiums ceded | (16,994 ) | (15,621 ) | (1,373 ) | 8.8 % |
| Net premiums written | 12,485 | 12,594 | (109 ) | (0.9 )% |
| Net premiums earned | 102 | 3,818 | (3,716 ) | (97.3 )% |
| Other related income | 5,677 | 4,127 | 1,550 | 37.5 % |
| Loss and loss adjustment expenses | 157 | (29 ) | 186 | (641.4 )% |
| Acquisition costs | (4,113 ) | (3,560 ) | (553 ) | 15.5 % |
| General and administrative expenses | (2,911 ) | (2,842 ) | (69 ) | 2.4 % |
| Underwriting (loss) income | $ (1,088 ) | $ 1,514 | $ (2,602 ) | 171.9 % |
| | | | | |
| Loss ratio (1) | (2.7 )% | 0.4 % | | (3.1 )% |
| Acquisition cost ratio (1) | 71.2 % | 44.8 % | | 26.4 % |
| General and administrative expense ratio (1) | 50.4 % | 35.8 % | | 14.6 % |
| Combined ratio (1) | 118.9 % | 81.0 % | | 37.9 % |

(1) For Island Heritage segment all ratios calculated using expenses divided by net premiums earned plus other related income.

- The increase in gross premiums written is primarily related to growth in the U.S. Virgin Islands and Bahamas, partially offset by decreased business in the Cayman Islands and Turks and Caicos. Contracts are written on a per risk basis and consist primarily of property lines.

- Premiums ceded were 57.6% of gross premiums written compared to 55.4% of gross premiums written for the same quarter in 2009.

  - Premiums ceded to Flagstone Suisse under our intercompany reinsurance programs were $9.1 million compared to $9.4 million for the same period in 2009. This amount is eliminated on consolidation.

  - Other related income consists primarily of quota share reinsurance ceding commissions. The other related income includes $4.4 million related to the quota share arrangement between Island Heritage and Flagstone Suisse. This amount is eliminated upon consolidation.

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Below is a summary of the underwriting results and ratios for our Island Heritage segment for the nine months ended September 30, 2010 and 2009:

| | For the nine months ended September 30, 2010 | 2009 | $ Change | % Change |
|---|---|---|---|---|
| Gross premiums written | $ 70,557 | $ 70,025 | $ 532 | 0.8 % |
| Premiums ceded | (65,886 ) | (63,535 ) | (2,351 ) | 3.7 % |
| Net premiums written | 4,671 | 6,490 | (1,819 ) | (28.0 )% |
| Net premiums earned | 5,073 | 4,694 | 379 | 8.1 % |
| Other related income | 16,822 | 14,815 | 2,007 | 13.5 % |
| Loss and loss adjustment expenses | (485 ) | (800 ) | 315 | (39.4 )% |
| Acquisition costs | (12,494 ) | (10,304 ) | (2,190 ) | 21.3 % |
| General and administrative expenses | (7,146 ) | (7,531 ) | 385 | (5.1 )% |
| Underwriting income | $ 1,770 | $ 874 | $ 896 | (102.5 )% |
| | | | | |
| Loss ratio (1) | 2.2 % | 4.1 % | | (1.9 )% |
| Acquisition cost ratio (1) | 57.1 % | 52.8 % | | 4.3 % |
| General and administrative expense ratio (1) | 32.6 % | 38.6 % | | (6.0 )% |
| Combined ratio (1) | 91.9 % | 95.5 % | | (3.6 )% |

(1) For Island Heritage segment all ratios calculated using expenses divided by net premiums earned plus other related income.

- The slight increase in gross premiums written is primarily related to continued growth in the Bahamas, offset by softening of rates in the U.S. Virgin Islands and the Cayman Islands. Contracts are written on a per risk basis and consist primarily of property lines.

- Premiums ceded were 93.4% of gross premiums written compared to 90.7% of gross premiums written for the same period in 2009.

- Premiums ceded to Flagstone Suisse under our intercompany reinsurance programs were $25.6 million compared to $26.9 million for the same period in 2009. This amount is eliminated upon consolidation.

- Other related income consists primarily of quota share reinsurance ceding commissions. The other related income includes $11.9 million related to the quota share arrangement between Island Heritage and Flagstone Suisse. This amount is eliminated upon consolidation.

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 noncontrolling interests in the investment portfolio, comprises investment income and realized and unrealized gains and losses on investments.

| | For the three months ended September 30, | | | For the nine months ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2010 | 2009 | % Change | 2010 | 2009 | % Change |
| Investment portfolio return | 2.6% | 2.0% | 0.6% | 3.3% | 3.1% | 0.2% |

- The change in return on invested assets during the three and nine months ended September 30, 2010 as compared to the same periods in 2009 is primarily due to positive performance of equity and commodities markets along with tightening of credit spreads and decreasing interest rates.

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Net investment income

Net investment income is derived from interest earned on investments, partially offset by investment management and custody fees.
The following table sets forth investment income for the three months ended September 30, 2010 and 2009:

| | For the three months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | 2009 | $ Change | % Change |
| Cash and cash equivalents | $462 | $915 | $(453) | (49.5)% |
| Fixed maturities investments | 8,574 | 10,910 | (2,336) | (21.4)% |
| Short term investments | 190 | 455 | (265) | (58.2)% |
| Equity investments | - | 12 | (12) | (100.0)% |
| Other investments | (56) | 61 | (117) | (191.8)% |
| Investment expenses | (1,682) | (1,574) | (108) | 6.9% |
| Net investment income | $7,488 | $10,779 | $(3,291) | (30.5)% |

- The decrease is principally due to amortization on our treasury inflation-linked securities and decreasing interest rates. In the current quarter, our treasury inflation-linked securities had lower amortization income compared to the same quarter of 2009, due to the lower inflation rates in the current quarter. These decreases were partially offset by the increase in asset level in the current quarter.

The following table sets forth investment income for the nine months ended September 30, 2010 and 2009:

| | For the nine months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | 2009 | $ Change | % Change |
| Cash and cash equivalents | $866 | $2,622 | $(1,756) | (67.0)% |
| Fixed maturities investments | 24,608 | 19,926 | 4,682 | 23.5% |
| Short term investments | 854 | 922 | (68) | (7.4)% |
| Equity investments | - | 60 | (60) | (100.0)% |
| Other investments | 689 | (11) | 700 | 6363.6% |
| Investment expenses | (4,025) | (3,847) | (178) | 4.6% |
| Net investment income | $22,992 | $19,672 | $3,320 | 16.9% |

- The increase is primarily due to the amortization on our treasury inflation-linked securities as well as the increase in asset level in the current year. During the nine months ended September 30, 2010, our treasury inflation-linked securities had higher amortization income compared to the same period in 2009, due to the higher inflation rates in the current period. These increases were partially offset by lower interest rates during the period.

Net realized and unrealized gains and losses – investments

The following table is the breakdown of net realized and unrealized gains - investments for the three months ended September 30, 2010 and 2009:

| | For the three months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | 2009 | $ Change | % Change |
| Net realized gains on fixed maturities | $766 | $8,733 | $(7,967) | (91.2)% |
| Net unrealized gains on fixed maturities | 86,867 | 21,570 | 65,297 | 302.7 % |
| Net realized gains on equities | - | 799 | (799) | (100.0)% |
| Net unrealized (losses) on equities | (29) | (407) | 378 | 92.9 % |
| Net realized and unrealized (losses) on derivative instruments - investments | (53,247) | (10,270) | (42,977) | (418.5)% |
| Net realized and unrealized gains on other investments | 5,808 | 861 | 4,947 | 574.6 % |
| Total net realized and unrealized gains - investments | $40,165 | $21,286 | $18,879 | 88.7 % |

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- The net realized and unrealized gains on the fixed maturities are primarily due to foreign exchange on non-U.S. dollar bonds, tightening of credit spreads and decrease in interest rates. Foreign exchange gains were largely offset by losses on derivatives used for foreign exchange hedging, as described in more detail below.

- The net realized and unrealized losses on derivative instruments are primarily due to net realized and unrealized losses on foreign currency forward contracts, as described in more detail below.

- The net realized and unrealized gains on other investments are primarily due to net realized and unrealized gains on catastrophe bonds.

The following table is a breakdown of net realized and unrealized gains – investments for the nine months ended September 30, 2010 and 2009:

| | For the nine months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | 2009 | $ Change | % Change |
| Net realized gains on fixed maturities | $16,641 | $13,188 | $3,453 | 26.2 % |
| Net unrealized gains on fixed maturities | 38,451 | 46,926 | (8,475) | (18.1)% |
| Net realized (losses) on equities | - | (2,482) | 2,482 | (100.0)% |
| Net unrealized (losses) gains on equities | (102) | 3,008 | (3,110) | (103.4)% |
| Net realized and unrealized (losses) on derivative instruments - investments | (23,191) | (32,273) | 9,082 | 28.1 % |
| Net realized and unrealized gains (losses) on other investments | 5,506 | (1,898) | 7,404 | 390.1 % |
| Total net realized and unrealized gains - investments | $37,305 | $26,469 | $10,836 | 40.9 % |

- The net realized and unrealized gains on the fixed maturities are primarily due to foreign exchange on non-U.S. dollar bonds, tightening of credit spreads and decreases in interest rates. Foreign exchange gains were largely offset by losses on derivatives used for foreign exchange hedging, as described in more detail below.

- The net realized and unrealized losses on derivative instruments are primarily due to net realized and unrealized losses on foreign currency forward contracts, as described in more detail below.

- The net realized and unrealized gains on other investments are primarily due to net realized and unrealized gains on catastrophe bonds.

The following table is a breakdown of the net realized and unrealized (losses) on derivatives included in the table above for the three months ended September 30, 2010 and 2009:

| | For the three months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | 2009 | $ Change | % Change |
| Futures contracts | $17,144 | $(1,041) | $18,185 | 1746.9 % |

| | | | | |
|---|---|---|---|---|
| Total return swaps | - | 2,036 | (2,036) | (100.0)% |
| Foreign currency forward contracts | (70,393) | (12,365) | (58,028) | (469.3)% |
| Mortgage-backed securities TBA | 2 | 1,100 | (1,098) | (99.8)% |
| Net realized and unrealized (losses) on derivatives - investments | $(53,247) | $(10,270) | $(42,977) | (418.5)% |

- The net realized and unrealized gains on future contracts are primarily due to positive performance of equity and commodities markets.

- The net realized and unrealized losses on foreign currency forward contracts are related to currency hedges on non-U.S. dollar bonds and are offset by net realized and unrealized gains on the fixed maturities as described above.

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The following table is a breakdown of the net realized and unrealized (losses) on derivatives included in the table above for the nine months ended September 30, 2010 and 2009:

| | For the nine months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | 2009 | $ Change | % Change |
| Futures contracts | $(3,209) | $3,261 | $(6,470) | (198.4)% |
| Total return swaps | 1,105 | (5,866) | 6,971 | 118.8 % |
| Foreign currency forward contracts | (21,977) | (31,909) | 9,932 | 31.1 % |
| Mortgage-backed securities TBA | 890 | 2,241 | (1,351) | (60.3)% |
| Net realized and unrealized (losses) on derivatives - investments | $(23,191) | $(32,273) | $9,082 | 28.1 % |

- The net realized and unrealized losses on future contracts are primarily due to negative performance of the commodities markets and decreases in interest rates which affected our short position in interest rate futures used to manage duration.
- The net realized and unrealized losses on foreign currency forward contracts are related to currency hedges on non-U.S. dollar bonds and are offset by net realized and unrealized gains on the fixed maturities as described above.

Treasury Hedging and Other

Net realized and unrealized gains and losses – other

Our policy is to hedge the majority of our non-investment currency exposure with derivatives 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.

The following table is the breakdown of net realized and unrealized gains - other for the three months ended September 30, 2010 and 2009:

| | For the three months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | 2009 | $ Change | % Change |
| Currency swaps | $1,818 | $819 | $999 | 122.0 % |
| Foreign currency forward contracts | 5,289 | 131 | 5,158 | 3937.4 % |
| Reinsurance derivatives | 570 | 423 | 147 | 34.8 % |

| | | | | | |
|---|---|---|---|---|---|
| Net realized and unrealized gains - other | $7,677 | $1,373 | $6,304 | 459.1 | % |

- The net gains associated with the currency swaps and foreign currency forward contracts are due to currency fluctuation which is partially offset by losses recorded through balance sheet currency revaluations and are attributable to Flagstone Suisse's net assets (undesignated hedge) and on operational hedges on reinsurance balances.

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The following table is the breakdown of net realized and unrealized gains – other for the nine months ended September 30, 2010 and 2009:

| | For the nine months ended September 30, | | | |
|---|---|---|---|---|
| | 2010 | 2009 | $ Change | % Change |
| Currency swaps | $(948) | $1,012 | $(1,960) | (193.7)% |
| Foreign currency forward contracts | 10,628 | 8,790 | 1,838 | 20.9% |
| Reinsurance derivatives | 1,689 | 1,471 | 218 | 14.8% |
| Net realized and unrealized gains - other | $11,369 | $11,273 | $96 | 0.9% |

- The net gains associated with the currency swaps and foreign currency forward contracts are due to currency fluctuation which is partially offset by losses recorded through balance sheet currency revaluations and are attributable to Flagstone Suisse's net assets (undesignated hedge) and on operational hedges on reinsurance balances.

Interest Expense

Interest expense was $2.7 million and $7.7 million for the three and nine months ended September 30, 2010, respectively, compared to $2.8 million and $9.5 million for the three and nine months ended September 30, 2009, respectively. Interest expense consists of interest due on outstanding debt securities and the amortization of debt offering expenses. The decrease in interest expense for the three and nine months ended September 30, 2010, compared to the same periods in 2009 is primarily related to the decrease in short term interest rates from period to period.

Foreign Exchange

For the three and nine months ended September 30, 2010, we experienced net foreign exchange losses of $17.1 million and $5.3 million, respectively, compared to losses of $2.4 million and $3.1 million for the three and nine months ended September 30, 2009, respectively. Net foreign exchange losses were principally experienced on the net monetary asset and liability balances denominated in foreign currencies. Our policy is to hedge the majority of our foreign currency exposures with derivative instruments such as foreign currency swaps and foreign currency forward contracts. Net realized and unrealized gains and losses on derivatives used to hedge those balances are included in "Net realized and unrealized gains – other" in the unaudited condensed consolidated statements of operations and comprehensive income.

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 Canada, Cyprus, India, Luxembourg, South Africa, Switzerland, the U.S. Virgin Islands ("USVI") and the United Kingdom. However, since the majority of our income to date has been earned in Bermuda where we are exempt from income tax, our tax impact to date has been minimal. During the three and nine months ended September 30, 2010, income tax expense was $1.0 million and $4.3 million, respectively, compared to $0.5 million and $0.1 million for the three and nine months ended September 30, 2009, respectively.

Noncontrolling Interest

The results of Mont Fort have been included in our unaudited condensed consolidated financial statements, with the portions of Mont Fort's net income and shareholders' equity attributable to the preferred shareholders recorded as noncontrolling interest since January 12, 2007, in accordance with the FASB ASC Topic on Consolidation. In relation to Mont Fort, we recorded a loss attributable to noncontrolling interest of $1.4 million and $13.1 million for the three and nine months ended September 30, 2010, respectively, compared to income attributable to noncontrolling interest of $7.7 million and $20.5 million, respectively, for the same periods in 2009. During the second quarter, losses of $22.9 million related to the Deepwater Horizon oil rig were recorded.

The results of operations of Island Heritage have been included in our unaudited condensed consolidated financial statements from July 1, 2007 onwards, with the portions of Island Heritage's net income and shareholders' equity attributable to minority shareholders recorded as noncontrolling interest. For the three and nine months ended September 30, 2010, we recorded a loss attributable to noncontrolling interest of $0.2 million and income of $1.0 million, respectively, compared to income attributable to noncontrolling interest of $0.9 million and $1.0 million for the three and nine months ended September 30, 2009, respectively.

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On November 10, 2009, Flagstone Suisse became the sole shareholder of Flagstone Africa by acquiring the remaining 35% of shares owned by Imperial Holdings Limited for a purchase price of $11.4 million. We recorded a loss attributable to noncontrolling interest of $0.7 million and $0.5 million for the three and nine months ended September 30, 2009, respectively.

Comprehensive Income

Comprehensive income attributable to Flagstone for the three and nine months ended September 30, 2010 was $42.7 million and $82.7 million, respectively, compared to $62.7 million and $171.6 million for the same periods in 2009. For the three months ended September 30, 2010, comprehensive income attributable to Flagstone included a net income of $35.7 million, $5.3 million for the change in the currency translation adjustment, $0.1 million for the change in the defined benefit pension plan obligations and $1.6 million related to comprehensive loss attributable to noncontrolling interest in subsidiaries compared to $76.5 million of net income, $(4.7) million for the change in the currency translation adjustment, $0.5 million for the change in the defined benefit pension plan obligation and $9.6 million related to comprehensive income attributable to noncontrolling interest in subsidiaries for the three months ended September 30, 2009. For the nine months ended September 30, 2010, comprehensive income attributable to Flagstone included $69.8 million of net income, $0.5 million for the change in the currency translation adjustment, $0.2 million for the change in the defined benefit pension plan obligation and a $12.2 million comprehensive loss attributable to noncontrolling interest in subsidiaries, compared to $192.8 million of net income, $2.6 million for the change in the currency translation adjustment, $0.1 million for the change in the defined benefit pension plan obligation and $23.9 million related to comprehensive income attributable to noncontrolling interest in subsidiaries for the nine months ended September 30, 2009.

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 contract is effective as a hedge, both the realized and unrealized gains and losses associated with the designated hedge instruments are recorded in other comprehensive income as part of the cumulative translation adjustment. We designated $42.8 million and $88.3 million of foreign currency forwards contractual value as hedge instruments, which had fair values of $(0.2) million and $(0.4) million, at September 30, 2010 and December 31, 2009, respectively. We recorded $4.3 million of realized and unrealized foreign exchange losses and $0.2 million of realized and unrealized foreign exchange gains on these hedges during the three and nine months ended September 30, 2010, respectively, and $2.1 million and $4.5 million of realized and unrealized foreign exchange losses on these hedges during the three and nine months ended September 30, 2009, respectively.

Financial Condition, Liquidity and Capital Resources

Financial Condition

At September 30, 2010, our total of investments, cash and cash equivalents, and restricted cash was $2.1 billion, compared to $1.9 billion at December 31, 2009.

The major factors contributing to the increase in the nine months ended September 30, 2010, were:

- Cash from operations of $232.7 million
- Cash used in investing activities of $111.0 million

- Common share repurchases of $72.4 million
- Repurchase of Mont Fort preferred shares of $79.5 million
- Distributions paid to shareholders of $9.5 million

Our investment portfolio on a risk basis, at September 30, 2010, comprised 87.2% fixed maturities, short term investments and cash and cash equivalents, 6.2% equities and the balance in other investments. We believe our investments can be liquidated and converted into cash within a very short period of time. However, our investments in investment funds, which represent 0.4% of our total investments and cash and cash equivalents at September 30, 2010, do not trade in active markets and are subject to redemption provisions that prevent us from converting them into cash immediately.

At September 30, 2010, all of the fixed maturity securities 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 AA+. At December 31, 2009, all of the fixed maturity securities in our investment portfolio, with the exception of $0.5 million, were rated investment-grade (BBB- or higher) by Standard & Poor's (or estimated equivalent) with an average rating of AA+.

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At September 30, 2010 and December 31, 2009, the average duration of our investment portfolio was 2.1 years and 2.3 years, respectively.

Other investments as at September 30, 2010, amounted to $108.7 million compared to $45.9 million at December 31, 2009. At September 30, 2010, the other investments comprised of $76.8 million in catastrophe bonds and $28.5 million in investment funds, which are recorded at fair value and our $3.4 million investment, which is accounted for under the equity method. The increase in other investments during the first nine months of 2010 is principally related to net purchases of catastrophe bonds and investment funds.

The net receivable for investments sold at September 30, 2010, was $9.1 million, compared to a net payable for investments purchased of $6.3 million at December 31, 2009. Net payables and receivables for investments are a result of timing differences only, as investments are accounted for on a trade date basis.

See Note 4 “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 nine months ended September 30, 2010 decreased to $232.7 million from $260.2 million as compared to the same period in 2009. This decrease in cash flows from operations was primarily related to lower net income and increased reinsurance premium receivables, offset by increased loss and loss adjustment expense reserves. Because a large portion of the coverages we provide typically can produce losses of high severity and low frequency, it is not possible to accurately predict our future cash flows from operating activities. As a consequence, cash flows from operating activities may fluctuate, perhaps significantly, between individual quarters and years.

Cash flows relating to financing activities include the payment of distributions to shareholders, share related transactions and the issuance or repayment of debt. During the nine months ended September 30, 2010, net cash of $160.8 million was used in financing activities, compared to net cash used in financing activities of $107.2 million for the nine months ended September 30, 2009. In the first nine months of 2010, the net cash used in financing activities related to the redemption of preferred shares in Mont Fort ILW 2, the repurchase of common shares held in treasury, and the payment of distributions to shareholders. In the first nine months of 2009, the net cash used by financing activities related principally to the redemption of preferred shares in Mont Fort ILW 1, the repurchase of common shares held in treasury, the payment of distributions to shareholders and the repayment of debt.

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

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

For the period from October 2005 until September 30, 2010, 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. We may require additional capital in the near term, whether through letters of credit or otherwise. 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 $309.0 million at September 30, 2010.

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Capital Resources

Our total capital resources at September 30, 2010 and December 31, 2009 were as follows:

| | As at | |
|---|---|---|
| | September 30, 2010 | December 31, 2009 |
| Long term debt | $ 251,472 | $ 252,402 |
| Common shares | 850 | 850 |
| Common shares held in treasury | (84) | (20) |
| Additional paid-in capital | 830,107 | 892,817 |
| Accumulated other comprehensive loss | (6,319) | (6,976) |
| Retained earnings | 399,499 | 324,347 |
| Total capitalization | $ 1,475,525 | $ 1,463,420 |

The movement in additional paid-in capital for the nine months ended September 30, 2010, primarily arises from $72.4 million for the repurchase of common shares held in treasury, offset by $13.3 million of stock based compensation.

For the nine months ended September 30, 2010, accumulated other comprehensive loss arose from the changes in currency translation adjustment of $0.5 million and the defined benefit pension plan obligation of $0.2 million.

Letter of Credit Facilities

Under the terms of certain reinsurance contracts, our reinsurance subsidiaries may be required to provide letters of credit to reinsureds in respect of reported claims and/or unearned premiums.

On June 5, 2009, Flagstone Suisse entered into a secured $50.0 million standby letter of credit facility with BNP Paribas (the “BNP Facility”). The BNP Facility had an initial term of one year and we decided to let the facility expire as per the terms of the agreement effective June 4, 2010.

On March 5, 2009, Flagstone Suisse entered into a $200.0 million secured committed letter of credit facility with Barclays Bank Plc (the “Barclays Facility”). The Barclays Facility is used to support our reinsurance obligations and those of our subsidiaries. As at September 30, 2010, $32.3 million had been drawn under the Barclays Facility, and the drawn amount was secured by $35.9 million of fixed maturity securities from our investment portfolio.

On April 28, 2010, Flagstone Suisse and Flagstone Capital Management Luxembourg SICAF–FIS entered into a secured $450.0 million standby letter of credit facility with Citibank Europe Plc (the “Citi Facility”). The Citi Facility comprises a $225.0 million facility for letters of credit with a maximum tenor of 15 months, to be used to support our reinsurance obligations and those of our subsidiaries, 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. As at September 30, 2010, $388.1 million had been drawn under the Citi Facility, and the drawn amount of the facility was secured by $435.5 million of fixed maturity securities from our investment portfolio. This facility replaces 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 are collateralized by the Company, at least to the extent of the letters of credit outstanding at any given time.

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Restrictions and Specific Requirements

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

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

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

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

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

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

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

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FSML and Syndicate 1861 are regulated by the Financial Services Authority ("FSA") in the United Kingdom. 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).

Off Balance Sheet Arrangements

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

We have determined that Valais 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, Valais Re is not consolidated because we do not hold a variable interest and as such are not the primary beneficiary.

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. We have entered into a reinsurance agreement with Montana Re that provides us with $175.0 million of protection for certain losses from global catastrophe events.

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 do not hold a variable interest and as such are not the primary beneficiary.

We are not party to any transaction, agreement or other contractual arrangement to which an affiliated entity unconsolidated with us is a party, other than that noted above with Valais Re and 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 "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 believe that currently we are principally exposed to four types of market risk: interest rate risk, equity price risk, credit risk and foreign currency risk.

Interest Rate Risk

Our primary market risk exposure is to changes in interest rates. 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 and we have the risk that cash outflows will have to be funded by selling assets, which will be trading at depreciated values. As interest rates decline, the market value of our fixed maturity portfolio increases and we have reinvestment risk since funds reinvested will earn less than is necessary to match anticipated liabilities. We expect to manage interest rate risk by selecting investments with characteristics such as duration, yield, currency and liquidity 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 September 30, 2010, the impact on our fixed maturity securities 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 2.0%, or approximately $35.2 million. As at September 30, 2010, the impact on our fixed maturity securities 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 2.2%, or approximately $38.7 million.

As at September 30, 2010, we held $386.3 million, or 24.4% of our fixed maturity portfolio in asset-backed and mortgage-backed securities. We did not hold any sub-prime securities at September 30, 2010. 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 of September 30, 2010 was $176.7 million. However, from a fair value perspective, futures are valued for only the unrealized gains and losses, but not for the exposure. As a result, the fair value of these positions as at September 30, 2010 amounted to $6.7 million and was recorded in both equities and other investments with net realized and unrealized gains of $21.8 million and $3.7 million, respectively, for the three and nine months ended September 30, 2010, recorded in net realized and unrealized gains - investments. The total exposure of the index-linked futures was $176.5 million as at September 30, 2010.

Credit Risk

We have exposure to credit risk primarily as a holder of fixed maturity securities. Our risk management strategy and investment guidelines have been defined to ensure we invest in debt instruments of high credit quality issuers and to limit the amount of credit exposure with respect to particular ratings categories and any one issuer. As at September 30, 2010, our fixed maturity investments consisted of investment grade securities with an average rating of AA+. 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.

We do not allow sub-prime investments by any investment manager and therefore do not have any exposure to credit risk associated with these types of securities. At September 30, 2010, we did not hold any Alt –A securities.

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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, total return 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 its trade balances receivable, namely insurance and reinsurance balances receivable. Premium balances receivable from our clients at September 30, 2010 and December 31, 2009, were $403.9 million and $279.0 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 cedent. Since our inception in October 2005, we have recorded $3.8 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. 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 low risk floating rate bonds. We believe that amalgamating the catastrophe risk in the catastrophe bonds with our other reinsurance risks produces more meaningful risk management reporting.

Foreign Currency Risk

We and our subsidiaries 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 of September 30, 2010 and December 31, 2009 was $847.4 million and $373.7 million. These contracts had a fair value of $(27.4) million and $5.8 million, respectively. The change results from an increased allocation to our non-U.S. dollar strategy, which is hedged back to U.S. dollar per our foreign exchange policy. During the three and nine months ended September 30, 2010, we recorded net realized and unrealized losses of $65.1 million and $11.3 million, respectively, on foreign currency forward contracts and for the three and nine months ended September 30, 2009, we recorded net realized and unrealized losses of $12.2 million and $23.1 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 converted to the functional currency (either U.S. dollar, Euro, British pound sterling or South African rand), and the time claims are paid.

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

Investments

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

Financing

When we or our subsidiaries issue a debt or equity financing in a currency other than the functional currency of that company, our practice is to hedge that exposure and designate the foreign currency contracts as hedging instruments. The contractual amount of these contracts as at September 30, 2010 and December 31, 2009 was $42.8 million and $88.3 million, respectively, and the contracts had a fair value of $(0.2) million and $(0.4) million, respectively. During the three and nine months ended September 30, 2010, we recorded $4.3 million of realized and unrealized losses and $0.2 million of realized and unrealized gains, respectively, directly into comprehensive income as part of the cumulative translation adjustment for the effective portion of the hedge. During the three and nine months ended September 30, 2009, we recorded $2.1 million and $4.5 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.

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 $18.4 million and will receive Euribor plus 354 basis points and pay LIBOR plus 367 basis points. The swap expires on September 15, 2011 and had a fair value of $(0.7) million as at September 30, 2010.

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 nine month periods ended September 30, 2010 and 2009, approximately 30.7% and 31.4%, respectively, was written in currencies other than the U.S. dollar. For the nine months ended September 30, 2010, we had net foreign exchange losses of $5.3 million compared to losses of $3.1 million for the same period in 2009.

We do not hedge currencies for which our asset or liability exposures are not material or where unable or 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 combined 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 we 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 our 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 statemen

Important events and uncertainties that could cause the actual results to differ include, but are not necessarily limited to: market conditions affecting our common share price; the possibility of severe or unanticipated losses from natural or man-made catastrophes; the effectiveness of our loss limitation methods; our dependence on principal employees; the cyclical nature of the insurance and reinsurance business; the levels of new and renewal business achieved; opportunities to increase writings in our core property and specialty reinsurance and insurance lines of business and in specific areas of the casualty reinsurance market; the sensitivity of our business to financial strength ratings established by independent rating agencies; the estimates reported by cedents and brokers on pro-rata contracts and certain excess of loss contracts 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; the amount and timing of reinsurance recoverables and reimbursements we actually receive from our reinsurers; the overall level of competition, and the related demand and supply dynamics in our markets relating to growing capital levels in the insurance and reinsurance industries; declining demand due to increased retentions by cedents and other factors; the impact of terrorist activities on the economy; and rating agency policies and practices.

These and other events that could cause actual results to differ are discussed in more detail from time to time in our filings with the SEC. We undertake 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. You 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 third fiscal quarter of 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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. However, investors are urged to carefully consider the “Risk Factors” section of the proxy statement that is part of Amendment No. 2 to the Company’s registration statement on Form S-4, which was filed with the SEC on April 9, 2010, for a discussion of risks solely related to the redomestication of the Company (as opposed to risks associated with the Company’s underlying business).

Item 1B. Unresolved Staff Comments

NONE.

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

Issuer Purchases of Equity Securities

| Period | (a) Total number of shares purchased | (b) Average price paid per share | (c) Total number of shares purchased as | (d) Maximum approximate |
|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| | | | | part of publicly announced program | dollar value ($ millions) of shares that may yet be purchased under the program |
| July 1 - July 31, 2010 | - | | N/A | - | N/A |
| August 1 - August 31, 2010 | 1,301,990 | $ | 10.45 | 1,301,990 | $ 12.4 |
| September 1 - September 30, 2010 | 118,970 | $ | 10.31 | 1,420,960 | $ 11.2 |
| Total | 1,420,960 | | | | |

On May 18, 2010, we announced that our Board of Directors had approved an increase in our share buyback program allowing us to purchase, from time to time, its common shares up to a value of $50.0 million, subject to market conditions, share price and other factors. The common share repurchase program does not have an expiration date.

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Item 3. Defaults upon Senior Securities

NONE

Item 5. Other Information

NONE

Item 6. Exhibits

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

SIGNATURES

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

Dated: November 2, 2010

FLAGSTONE REINSURANCE HOLDINGS, S.A.

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

(Authorized Officer)

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

(Principal Financial Officer)

EXHIBIT INDEX
Pursuant to Item 601 of Regulation S-K

| Exhibit No. | Description of Exhibit |
|---|---|
| 31.1 | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, with respect to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2010. |
| 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 September 30, 2010. |
| 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 September 30, 2010. |
| 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 September 30, 2010. |