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(see note on last page)

**Internal Audit Report**

DATE: February 4, 2008

TO: Robert Upton                      CC: Distribution

FROM: Ian Cox  
Simon Dalby  
Mark Dankenbrink  
Richard Dellolio

RE: **Global Review of Corporate Treasury and  
Funding/Liquidity Risk Management**

**I. EXECUTIVE SUMMARY**

As an SEC Consolidated Supervised Entity ("CSE"), Internal Audit is required to perform periodic reviews of the Firm's Internal Risk Management Control Systems, pursuant to SEC Rule 15c3-4(c)(5)v. These reviews cover Risk Oversight and Governance, Functional Risk Management, and Business Line Risk Management. As part of our coverage of Risk Oversight and Governance and Functional Risk Management, we performed a limited review of Corporate Treasury and Funding/Liquidity Risk Management. Our review did not disclose any significant weaknesses in internal controls or significant violations of Firm policies and procedures. Issues identified during the review, along with the corresponding management action plans/action taken, as applicable, are included in Section III.

**II. BACKGROUND AND SCOPE**

Corporate Treasury, reporting to Robert Upton, SMD and Treasurer of The Bear Stearns Companies Inc., is comprised of several functions, including Global Funding and Funding/Liquidity Strategy and Analytics.

The Global Funding Desk ("Desk"), managed by John Stacconi, SMD, is responsible for financing a significant portion of the Firm's balance sheet via short-term funding (e.g., commercial paper, equity repo, FX swaps and bank financing), as well as through medium-term notes, long-term debt, and structured notes. The Desk operates out of New York, London, and Hong Kong.

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Corporate Treasury has established a liquidity risk management framework for the Firm, designed to provide flexibility to address liquidity events, maintain stability and continuity in all market environments, and which includes targets and guidelines around key liquidity measures. A fundamental premise of the liquidity framework is that the Firm will not be reliant upon forced balanced sheet reduction to endure a period of constrained funding availability.

A monthly Funding and Liquidity Package ("FLiP") is produced and distributed to senior management. This package includes two of the key concepts and metrics of the liquidity risk management framework, the Liquidity Ratio and Net Cash Capital calculations. These two analyses evaluate the ability of the Firm to survive a funding crisis over a one-year time horizon assuming no liquidation of assets and no access to additional unsecured funding. Using these assumptions, the Funding/Liquidity Strategy and Analytics Group monitors the Firm's cash position, liquidity pool, and unencumbered financial instruments against unsecured debt maturing over the next twelve months and seeks to maintain cash capital in excess of that portion of its assets that cannot be funded on a secured basis.

Corporate Treasury is supported by Treasury Controllers, which is headed by George Ilario, MDP, who reports to Anthony Nardella, SMD.

In addition, the Global Finance Committee ("Committee") provides oversight and governance over the Firm's funding/liquidity risk management. The Committee determines, implements, and monitors the Firm's liquidity, funding, capital, and balance sheet guidelines and usage. The Committee is also responsible for setting liquidity risk management practices/processes and has oversight over the implementation of, and adherence to, the global funding framework. Robert Upton is Chairman of the Committee and other members include: John Stacconi, Paul Friedman, Anthony Nardella, Jeremy Hill and Patrick Lewis.

The scope of this review included an evaluation of the Global Finance Committee and procedures and controls around the Funding/Liquidity Strategy and Analytics Group, focusing on the Net Cash Capital calculation (the Liquidity Ratio was tested as part of our 2006 review of Corporate Treasury). Also as part of this review, Internal Audit assisted the Sarbanes-Oxley Compliance Office ("SCO") in performing management testing, as required under Section 404 of the Sarbanes-Oxley Act of 2002.

### **III. ISSUES AND MANAGEMENT ACTION PLANS/ACTION TAKEN**

#### **1. Mandatory Auction Call Trades**

In August and September 2007, Bear Stearns sold approximately \$2 billion of mortgage-backed securities to two mutual funds under agreements, known as "mandatory auction calls," by which the securities will be auctioned off in August and September 2008 and January 2009. Bear Stearns will receive any excess of the auction

proceeds over par and pay any deficit of the auction proceeds below par to the funds. If no bids are received at auction, Bear Stearns has agreed to purchase the securities at par. Although derivative transactions have been recorded that capture the market risk and P&L associated with these agreements, the potential impact on liquidity and cash capital was not being considered. Corporate Treasury should account for these transactions in the Net Cash Capital calculation, as well as identify and include any other similar transactions that may be outstanding.

**Management Action Plan – Patrick Lewis – SMD – Corporate Treasury**

We will spearhead an effort to educate senior managers on the importance of reporting all potential off-balance sheet funding requirements to Corporate Treasury. In addition, we will seek senior management approval to include a member of Corporate Treasury on the Firm's New Products Committee. Target Date is May 30, 2008.

With respect to the specific trades mentioned above, an assessment has been made regarding the cash capital requirements and will be reflected in the January 31, 2008, FLiP, which will be issued by February 29, 2008.

**2. Monetization of Unencumbered Collateral In Excess of Committed Facilities**

Corporate Treasury has made an assumption that unencumbered collateral can be monetized in excess of existing committed facilities. If this assumption proves false, the Firm is relying on liquidity in a stress scenario that may not actually be available.

**Management Action Plan – Patrick Lewis – SMD – Corporate Treasury**

The basic assumption that the Firm would have access to more secured funding than is currently contractually provided by existing commitments has been an operating premise of the Firm's cash capital and liquidity risk management approach since the inception of the Firm-wide cash capital model in 2001.

We have been actively working to reduce our exposure to unsecured funding since late 2006. As a result, our reliance on unsecured funding has dropped significantly and, therefore, the assumption that additional secured funding beyond contractual commitments will be available is becoming less of a concern. If, by August 29, 2008, all collateral has not been pledged in a secured funding transaction, or funded with 100% cash capital, we will revisit the assumption that excess liquidity beyond existing unused committed facilities would be readily available.

### **3. Derivative Payables/Receivables**

Payables and receivables, arising from marking-to-market derivative positions, are being netted and included in the Net Cash Capital calculation as a "source," in the case of a net payable, or a "use," in the case of a net receivable, of cash capital. The net payable/receivable is included in order to offset the haircuts on the appreciation/depreciation of the corresponding cash hedges. Corporate Treasury should review the various components of the Derivative Payable/Receivable computation for adequacy, including the treatment for both long and short hedge positions and the effect of netting the gross payables and receivables. For example, the current methodology allows excess cash capital sources from one trade/strategy to offset a need for cash capital in an unrelated trade/strategy.

#### **Management Action Plan – Patrick Lewis - SMD – Corporate Treasury**

The cash capital requirements and liquidity risk for the Derivative businesses are constantly being refined. The issue described above is understood and has been studied and discussed among senior members of Corporate Treasury, Risk Management, the Derivative business units, and with the Firm's Chief Financial Officer. We plan to develop an alternative proposal to the current methodology and present it to the Derivative business units by May 30, 2008.

### **4. Consider a Separate FLiP Report for Asia**

Corporate Treasury does not prepare separate FLiP Reports for the Asian entities (i.e., Bear, Stearns Asia Limited, Bear, Stearns (Japan) Limited, and Bear, Stearns Singapore Pte Limited).

#### **Management Action Plan – Patrick Lewis – SMD – Corporate Treasury**

We will produce an "Asian FLiP" by March 31, 2008, and, going forward, will consider producing the report periodically based on the results of the initial review, the growth in the region, or as required by regulators.

### **5. Written Policies and Procedures Should be Developed**

Corporate Treasury does not have written policies and procedures that document the methodologies and assumptions utilized in the Net Cash Capital and Liquidity Ratio calculations. Policies and procedures around the calculations should be formally documented and approved by the Global Finance Committee ("GFC").

#### **Management Action Plan – Patrick Lewis – SMD – Corporate Treasury**

We will update and/or refine existing documentation for GFC approval by August 29, 2008.

## **6. Error in Reporting to the Global Finance Committee**

A schedule of the Firm's short-term liquidity position, which includes any long-term debt maturing in the next 60 days, is distributed to the GFC on a weekly basis. In reviewing the report for one week, we identified that the level of long-term debt maturing in the next 60 days was understated by \$89 million, as the maturity profile did not capture long-term debt maturing on non-business days. As a result, the short-term liquidity position was inaccurately reported to the GFC.

### **Management Action Taken – John Stacconi – SMD – Corporate Treasury**

Long-term debt maturing on non-business days is now being included in the schedule of the Firm's short-term liquidity position.

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