
Salomon Swapco Inc.

Analysts:

Nik Khakee, New York (1) 212-438-2473
Krishan Nagpal, New York (1) 212-438-2552

Credit Rating

AAA_t

Outstanding Rating(s)

Counterparty credit AAA_t

Credit Rating History

Feb. 8, 1993 AAA_t

Sovereign Rating

United States of America AAA/Stable/A-1+

Rationale

The ‘AAA_t’ counterparty rating assigned to Salomon Swapco Inc. is based upon Standard & Poor’s assessment of Swapco’s legal, financial, and operating structure. Swapco, a wholly owned subsidiary of Salomon Brothers Holding Company (SBHC), was incorporated under the laws of Delaware. It was the first ‘AAA_t’ vehicle rated by Standard & Poor’s, and was established to transact in a variety of derivative products, including swaps and options on interest rates, currencies, and equities. The “t” suffix reflects Swapco’s incorporation of a termination feature requiring that all of Swapco’s derivative contracts accelerate and cash-settle upon certain trigger events. The rating reflects Swapco’s extremely strong financial capacity to meet all the obligations of its derivative transactions, in accordance with their terms, whether at maturity or upon termination. The rating does not address the likelihood of a termination event.

Standard & Poor’s decision to rate Swapco’s ability to repay its counterparties with ‘AAA_t’ certainty is also based upon the capitalization and limit structure of the vehicle. Swapco’s capital requirement is the greater of US\$175 million or a dynamic capital amount calculated daily, based on the size, credit quality, and concentration of the exposure in its portfolio, providing Swapco with incentive to maintain a diversified portfolio of high credit quality counterparties.

Swapco acts as an intermediary between SBHC and third-party counterparties. For each transaction with a counterparty, Swapco enters into a exact offsetting mirror

transaction with SBHC, thus eliminating its market exposure. Protection against credit exposure to SBHC is provided primarily by collateral posted by SBHC to Swapco. Protection against credit exposure to Swapco's counterparties is provided by Swapco's capital.

On Nov. 28, 1997, Salomon Inc., Swapco's indirect parent, combined with Travelers Group's Smith Barney Holdings Inc. to form Salomon Smith Barney Holdings Inc. There was no adverse impact on Swapco resulting from this change to Swapco's ultimate ownership, and accordingly, Standard & Poor's reaffirmed Swapco's 'AAAt' rating at that time.

Swapco was rated on Feb. 8, 1993. Since its inception, Swapco has been expanding its portfolio's notional and counterparty base at a very solid rate. As of June 22, 1998, Swapco's outstanding derivative portfolio notional was US\$279 billion. Required capital as of Dec. 31, 1997, was US\$255 million.

Legal Risks

An important part of Standard & Poor's analysis relates to the examination of the legal implications of Swapco's structure. A major area of concern is the establishment of Swapco as a legally independent entity not subject to consolidation with any other in the event of the insolvency or bankruptcy of SBHC or any affiliate. To achieve this, Swapco has incorporated a number of structural and operational provisions to provide a basis for legal treatment as a separate entity. Standard & Poor's has also received the opinion of legal counsel that, subject to certain assumptions and based on certain justifications, Swapco should not be consolidated with SBHC or its affiliates upon their bankruptcy or insolvency.

Another area of particular concern in the analysis of a derivative products company relates to the legal enforceability of the netting provision in standard swap documents. In the United States, the enforceability of netting has been confirmed by the Bankruptcy Code. However, Standard & Poor's believes that in some other countries, there is the risk netting will not be enforceable. In this case, Swapco's potential credit loss to a counterparty would be the sum of all amounts owed to Swapco by a counterparty without offsetting the amounts owed to the counterparty by Swapco (gross exposure). Therefore, Standard & Poor's believes that allowances have to be made for the possibility that the relevant exposure in many jurisdictions is the gross exposure to a counterparty and not the net exposure. To address this concern, Swapco's dynamic capital calculation incorporates certain calculations that provide for the measurement of gross exposures in these jurisdictions. The legal opinions received by Standard & Poor's are based on certain assumptions and are subject to qualification.

Financial Risks

Swapco's portfolio consists primarily of interest rate and currency swaps. However, options, swap options, forwards on interest rates, currencies, and equities are also permitted transactions. Adherence to a statement of procedures requires Swapco not to enter into derivative transactions with counterparties rated below investment grade (rated 'BBB-'). In general, the amount of capital required increases for lower-rated counterparties. The increased cost of higher capitalization provides an incentive for Swapco to maintain a high credit quality portfolio. If a previously eligible counterparty is subsequently downgraded to below investment grade, Swapco is not required to assign or terminate the transaction, but will no longer be able to enter into new transactions with that counterparty, unless they reduce Swapco's potential credit exposure to that counterparty. All exposure to noninvestment-grade counterparties must be fully capitalized. Swapco may transact with unrated counterparties, but similarly, all exposures must be fully capitalized, unless and until Standard & Poor's assesses the credit quality of the counterparty to be at least investment grade. If Standard & Poor's determines the credit quality of the counterparty to be at least investment grade, the counterparty will be treated for capitalization purposes as a 'BBB-' rated entity. Swapco may guarantee transactions entered into by other approved Salomon Smith Barney affiliates. These transactions are treated as direct obligations of Swapco when calculating exposure in the daily dynamic capital calculation.

The nature of Swapco's structure mirroring all transactions with SBHC means that, provided there aren't any counterparties failing to make timely payments, Swapco is effectively a conduit, passing payments from SBHC to customers, and from customers to SBHC. For its credit intermediation, Swapco receives an intermediation fee from SBHC. If, however, a counterparty fails to make a payment, Swapco must be able to make the matching payment on the corresponding back-to-back transaction out of its capital. If a customer defaults and its transactions are terminated and if the customer is out-of-the-money (the customer owes a payment to Swapco), Swapco terminates the matching transaction with SBHC and must make a termination payment to SBHC, regardless of the amount it collects from the customer. This situation could result in a consumption of capital equal to the net market value of transactions with the customer (net exposure) or the gross market value of the transactions (gross exposure). The gross exposure is realized if a foreign jurisdiction enforces only those contracts between the customer and Swapco that are favorable to the customer. In either case, if the capital consumed causes the remaining capital to fall below the dynamic daily capital requirement, Swapco will have a two-day cure period to remedy the shortfall or a termination event will be triggered.

If SBHC defaults or any other termination event is triggered, all counterparty transactions are accelerated. All termination payments owed to Swapco by

counterparties are due five days after the valuation date. All termination payments owed by Swapco to counterparties are due 10 days after valuation. Thus, Swapco relies on capital for all termination payments owed to it but not paid within that five-day period. Termination payments owed to Swapco by SBHC are covered separately by collateral posted by SBHC and held by Swapco's trustee. The collateral may be used solely to meet the SBHC's obligation to Swapco. Swapco's capital may be used for any purpose, including coverage of any amount owed by SBHC in the unlikely event that collateral posted is insufficient.

Swapco's capitalization is based on the greater of US\$175 million or a daily dynamic capital calculation, requiring Swapco to maintain capital based on the size, concentration, and credit quality of the exposure in its portfolio. Swapco's dynamic capital calculation incorporates several subcalculations, each one designed to address specific portfolio risks. As Swapco's portfolio notional grows and exposures increase, the dynamic nature of the capital formula requires additional capital to address the risks of a larger portfolio.

Each day, Swapco performs two computations. The first is the actual capital of Swapco, equal to the difference between Swapco's assets and its liabilities minus the haircuts discussed below. The second is the dynamic calculation of minimum capital requirement. Because Swapco's portfolio is perfectly matched by mirror transactions with SBHC, changes in the level of underlying indices do not affect the value of actual capital. Changes in market levels do, however, affect the amount of required capital due to the resulting change in the value of individual transactions and, consequently, customer exposures. Each day, Swapco's actual capital must exceed that day's minimum capital requirement, or a termination event is triggered if not cured within two days. Therefore, if Swapco suffers a credit loss that causes its actual capital to fall below the required capital, or if changes in market levels cause the required capital to increase above the actual capital, Swapco has two days to receive additional capital or to reduce customer exposures to avoid triggering a termination event.

The existence of the offsetting back-to-back transactions with SBHC results in a potentially large credit exposure to Swapco. Swapco has addressed this risk through a dynamic collateral formula. SBHC posts collateral to Swapco daily in an amount equal to Swapco's exposure to SBHC plus a market-exposure cushion. If SBHC fails to post the required collateral, a termination will occur following a two-day cure period. The collateral cushion is designed to cover the potential increase in exposure between the last good valuation date and the date that all contracts are valued in a termination. In addition, the required collateral cushion increases if Salomon Smith Barney Holdings Inc.'s rating is lowered below certain levels.

In the event that Swapco has a negative exposure to SBHC, Swapco may post collateral to SBHC, if available. Collateral will be posted by Swapco in an amount equal to SBHC's exposure to Swapco less the market risk cushion amount. Offsetting

the exposure amount against the cushion amount protects Swapco if the ultimate payable to SBHC decreases during the termination process. Standard & Poor's has assessed Swapco's capital and collateral formulas under stressful market conditions, and in the case of capital, assumed severe counterparty defaults, and determined them to be consistent with an 'AAAt' counterparty rating.

All of Swapco's capital and collateral is invested in certain permitted securities rated 'AAA' by Standard & Poor's. Additionally, securities are subject to Standard & Poor's overcollateralization and capital haircuts to account for potential decreases in the securities' market value between the last good valuation date and the date securities will be liquidated in a termination scenario.

Operating Risks

The counterparty rating assigned to Swapco blends elements of structured finance and unsecured financial analysis to assess capital adequacy for an operating entity with a dynamic portfolio of derivative products. A key component in determining the adequacy of Swapco's capital is the structural termination feature, which requires that all of Swapco's derivative contracts be cash settled within a predetermined period of time upon certain termination trigger events. The existence of termination events linked to the maintenance of capital, collateral, and liquidity ensures that Swapco will have liquid assets, consistent with a 'AAAt' rating, in the form of portfolio receivables and invested capital to meet the payment obligations of a potential termination process. In the event of a termination, each Swapco counterparty will either pay or receive a net termination amount representing Swapco's determination of the midmarket value of all transactions between Swapco and that counterparty. Swapco disseminates termination values to every counterparty every quarter on every outstanding transaction that it has with Swapco.

Swapco has incorporated five termination trigger events:

- Failure by SBHC to post the required collateral to Swapco within a two-day cure period;
- Failure by Swapco to maintain actual capital equal to the required capital, subject to a two-day cure period;
- Failure by Swapco to maintain the minimum required liquidity amount in the form of cash or cash-equivalent investments, subject to a two-day cure period;
- Downgrade of Swapco's counterparty rating below the 'A' category by any of its rating agencies; and
- Bankruptcy of Salomon Smith Barney Holdings Inc., SBHC, or any another Salomon Smith Barney affiliate that has outstanding guaranteed transactions.

If a termination trigger event occurs, Swapco will notify its counterparties within one business day that a termination event has occurred and will provide the expected date for valuation of each counterparty's transactions. All transactions will then terminate and be valued on that date unless a market disruption event occurs, as defined in Swapco's swap documents, or unusually chaotic market conditions exist, as determined by a random poll of Swapco counterparties. If either of these conditions exists, the valuation process will be delayed until the conditions cease, but no longer than eight business days. If chaotic conditions exist in isolated markets, Swapco will delay valuation of only those contracts related to the disrupted markets (at the option of the counterparty) and proceed with the valuation of all other contracts. On the valuation date, Swapco will poll market participants or otherwise ascertain the midmarket inputs to be used in its valuation model to price the terminated contracts. Swapco's valuation models are reviewed weekly by its independent auditors for consistency with industry standards. Once the valuation has been completed, Swapco will notify each counterparty on the date of its net termination payable or receivable. All counterparties with net termination amounts that are payable to Swapco will be required to make payments within five business days of the valuation date. All counterparties with net termination amounts that are receivable from Swapco will be paid within 10 business days of the valuation date.

Under its statement of procedures, Swapco is permitted to offer customers the option to enter into two-way mark-to-market agreements. These agreements require the counterparty out-of-the-money to post collateral to the counterparty in-the-money. To address the potential liquidity requirements of these agreements, Swapco maintains liquidity lines from SBHC.

General, day-to-day management of Swapco's overall liquidity needs is carried out by Swapco's financial officer. Similar to the capital requirement, Swapco has to maintain a liquidity amount that is the greater of a fixed monetary amount or a formulaic amount based on required capital. However, to ensure liquidity mismanagement does not lead to an actual payment default on derivative products obligations by Swapco, Swapco has incorporated a liquidity termination trigger. If Swapco fails to maintain the minimum liquidity amount, a termination will occur in which all assets are liquidated and liquidity is assured at the value of the investments.

Swapco's statement of procedures requires that independent auditors (Price Waterhouse Coopers) verify each week Swapco's compliance with capital and collateral requirements, as well as counterparty and product restrictions. The independent auditors will also observe all aspects of the termination process in the event of a termination.

Swapco executes master swap agreements based on International Swap and Derivatives Association documentation with each of its counterparties. Each master swap agreement specifies Swapco's termination trigger events and describes the

termination procedure. Swapco's standard master agreement informs customers that full two-way payments will be required upon early termination and that there will not be any cross-default to, or set-off against, SBHC or any other Salomon Smith Barney affiliate for Swapco transactions.