

Notes to the Consolidated Financial Statements

29. FINANCIAL RISK MANAGEMENT

The Company is exposed to the following risks as a result of holding financial instruments: credit risk, market risk and liquidity risk. The following is a description of those risks and how the exposures are managed.

Credit Risk

The Company is exposed to credit risk resulting from the possibility that counterparties may default on their financial obligations. Exposure to credit risk relates to derivative instruments, cash equivalents, short term investments, security deposits included in other assets, pension assets held in the Company's defined benefit plans, amounts receivable from Weston Foods customers and suppliers, *PC Bank's* credit card receivables and other Loblaw receivables from independent franchisees, associated stores and independent accounts.

The Company may be exposed to losses if a counterparty to the Company's financial or non-financial derivative agreements fails to fulfill its obligations. The Company has sought to minimize potential counterparty risk and losses by conducting transactions for its derivative agreements with counterparties that have at minimum a long term "A" credit rating from a recognized credit rating agency and by placing risk adjusted limits on its exposure to any single counterparty for its financial derivative agreements. The Company has internal policies, controls and reporting processes, which require ongoing assessment and corrective action, if necessary, with respect to derivative transactions. In addition, net obligations and asset amounts on cross currency swaps and equity swaps and forwards are each netted by agreement with counterparties.

Credit risk associated with the Company's cash equivalents, short term investments and security deposits included in other assets results from the possibility that a counterparty may default on the repayment of a security. The Company attempts to mitigate this risk through policies and guidelines that require issuers of permissible investments to have at minimum a long term "A" credit rating from a recognized credit rating agency and that specify minimum and maximum exposures to specific industries, issuers and types of investment instruments. The Company purchases and holds these investments directly in custody accounts and has limited exposure to any third-party money market portfolios and funds.

Weston Foods performs ongoing credit evaluations to assess the financial condition of its new and existing suppliers and customers for amounts receivable from these counterparties.

Loblaw's exposure to credit risk from *PC Bank's* credit card receivables and receivables from independent franchisees, associated stores and independent accounts results from the possibility that customers may default on their payment obligation. *PC Bank* manages the credit card receivable risk by employing stringent credit scoring techniques, actively monitoring its credit card portfolio and reviewing techniques and technology that can improve the effectiveness of the collection process. In addition, these receivables are dispersed among a large, diversified group of credit card customers. Loblaw accounts receivable from independent franchisees, associated stores and independent accounts are actively monitored on an ongoing basis and settled on a frequent basis in accordance with the terms specified in the applicable agreements.

The Company's maximum exposure to credit risk as it relates to derivative instruments is represented by the positive fair market value of the derivatives on the balance sheet (see note 28).

See note 12 for additional information on the credit quality performance of *PC Bank's* credit card receivables, Loblaw accounts receivable from independent franchisees, associated stores and independent accounts and Weston Foods customers.

Market Risk

Market risk is the loss that may arise from changes in factors such as interest rates, foreign currency exchange rates, commodity prices, common share prices and the impact these factors may have on other counterparties.

Interest Rate Risk

The Company is exposed to interest rate risk, which it manages through the use of interest rate swaps. The Company's interest rate risk arises from the issuance of short term debt and equity derivatives, net of its cash and cash equivalents, short term investments and security deposits included in other assets. The Company manages fluctuations in its interest expense through its exposure to a mix of fixed and floating interest rates, by managing the duration of its financial instruments and by entering into interest rate swaps.

The Company estimates that a 100 basis point increase (decrease) in interest rates, with all other variables held constant, would result in an increase (decrease) of \$18 to interest expense and other financing charges.

Foreign Currency Exchange Rate Risk

As at year end 2008, the Company had \$1.5 billion (2007 – \$1.1 billion) in cash and cash equivalents, \$694 (2007 – \$461) in short term investments and \$560 (2007 – \$419) in security deposits included in other assets, the majority of which are denominated in United States dollars and are held or managed by Glenhuron.

Loblaw is exposed to foreign currency exchange rate variability, primarily on its United States dollar denominated cash and cash equivalents, short term investments, security deposits included in other assets, foreign denominated purchases in accounts payable and accrued liabilities, and USD private placement notes included in long term debt. To manage its foreign currency exchange rate exposure, Loblaw enters into cross currency swaps. As a result, a significant strengthening (weakening) of the Canadian dollar against the United States dollar, with all other variables held constant, would not have a significant impact on net earnings before income taxes and minority interest. To manage its foreign currency exchange rate risk, Loblaw designates a portion of its cross currency swaps in a cash flow hedge of the exposure to fluctuations in the foreign currency exchange rate on a portion of its United States dollar denominated cash and cash equivalents, short term investments and security deposits included in other assets. The remaining undesignated cross currency swaps economically hedge exposure to fluctuations in the foreign currency exchange rate on the remaining United States dollar denominated cash and cash equivalents, short term investments, security deposits included in other assets and the USD private placement notes.

During 2008, the unrealized foreign currency exchange gain of \$50 (2007 – loss of \$79) before income taxes and minority interest related to the cash and cash equivalents, short term investments and security deposits included in other assets classified as available-for-sale was recognized in accumulated other comprehensive loss and was partially offset by the unrealized foreign currency exchange rate loss of \$51 (2007 – gain of \$72) before income taxes and minority interest relating to the designated cross currency swaps also deferred in accumulated other comprehensive loss. The unrealized foreign currency exchange gain of \$160 (2007 – loss of \$76) on the designated held-for-trading cash and cash equivalents, short term investments and security deposits included in other assets is partially offset in operating income by the unrealized foreign currency exchange rate loss of \$157 (2007 – gain of \$79) relating to the cross currency swaps which are not designated in a cash flow hedge. During 2008, Loblaw realized a foreign currency exchange gain of \$26 (2007 – \$46) relating to cross currency swaps that matured or were terminated.

During 2008, the Company recognized in operating income an unrealized foreign currency exchange loss of \$65 related to Loblaw's USD \$300 fixed rate private placement notes. This was partially offset by both the effective portion of the designated cross currency swaps that was reclassified from other comprehensive income to operating income and the fair value gain of the cross currency swaps that are not designated in a hedging relationship. At the inception of the cash flow hedge, a nominal amount of ineffectiveness was recognized in operating income.

The Company's consolidated financial statements are expressed in Canadian dollars, however a portion of its Weston Foods business is in United States dollars through its net investment in self-sustaining foreign operations in the United States ("U.S. net investment"). The U.S. net investment is translated into Canadian dollars at the foreign currency exchange rate in effect at the balance sheet date. As a result, the Company is exposed to exchange rate gains and losses which are recorded in other comprehensive income (loss). During 2008, the Canadian dollar depreciated (2007 – appreciated) relative to the United States dollar, resulting in an increase (2007 – reduction) of the Company's U.S. net investment and a corresponding increase in other comprehensive income of \$677 (2007 – increase in other comprehensive loss of \$508). As a result of the sale of its U.S. fresh bakery business, the Company expects to recognize a portion of the cumulative foreign currency translation loss currently reflected in shareholders' equity associated with the U.S. net investment in net earnings in 2009. In addition, revenues and expenses of these self-sustaining foreign operations are translated into Canadian dollars at the foreign currency exchange rates that approximate the rate in effect at the date when such items are recognized. An appreciating Canadian dollar relative to the United States dollar will negatively impact year-over-year changes in reported sales, operating income and net earnings, while a depreciating Canadian dollar relative to the United States dollar will have the opposite impact.

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Commodity Price Risk

Weston Foods costs are directly impacted by fluctuations in the price of commodities such as wheat, flour, sugar, vegetable oil, cocoa, natural gas and fuel. Loblaw is exposed to increases in the prices of commodities in operating its stores and distribution centres, as well as the indirect link of commodities to its consumer products. To manage this exposure, Loblaw uses purchase commitments for a portion of its needs for certain consumer products that may be commodities based and Loblaw expects to take delivery of these consumer products in the normal course of business. In addition, both Weston Foods and Loblaw use financial and non-financial derivative instruments in the form of futures contracts, option contracts and forward contracts to manage their current and anticipated exposure to fluctuations in commodity prices. The Company estimates that a 10% increase (decrease) in relevant commodity prices, with all other variables held constant, would result in a net gain (loss) of \$13 in net earnings before income taxes and minority interest.

Common Share Price Risk

GWL and Loblaw enter into equity derivatives to manage exposure to fluctuations in stock-based compensation cost as a result of changes in the market prices of the respective underlying common shares. The equity derivatives allow for settlement in cash, common shares or net settlement. These derivatives change in value as the market prices of the respective underlying common shares change and provide a partial offset to fluctuations in stock-based compensation cost, including RSU plan expense. The partial offset between stock-based compensation costs, including RSU plan expense, and the equity derivatives is effective when the market price of the respective underlying common shares exceeds the exercise price of the related employee stock options. When the market price of the respective underlying common shares is lower than the exercise price of the related employee stock options, these equity derivatives will provide a partial offset only to the RSU plan expense. The amount of net stock-based compensation cost recorded in operating income is mainly dependent upon the number of unexercised stock options and RSUs and their vesting schedules relative to the number of respective underlying common shares on the equity derivatives and the level of and fluctuations in the market price of the respective underlying common shares. A one dollar increase (decrease) in the market value of the respective underlying shares of the equity swaps and forwards, with all other variables held constant, would result in a gain (loss) of \$6 in net earnings before income taxes and minority interest.

In addition, the obligation of GWL under the equity forward sale agreement based on 9.6 million Loblaw common shares, which matures in 2031, is secured by the underlying Loblaw common shares. GWL entered into this forward to partially offset any repayment risk associated with its Series A, 7.00% and Series B Debentures. Further, if the market value of the underlying Loblaw common shares exceeds the obligation of the Company under this forward, a portion of the proceeds from a future sale of these shares may be used to satisfy the obligation under this forward contract upon termination or maturity. At maturity, if the forward price is greater than the market price of the Loblaw shares, GWL will receive a cash amount equal to the difference. If the forward price is less than the market price of the Loblaw shares, GWL will pay a cash amount equal to the difference. A one dollar increase (decrease) in the market value of the underlying shares of the equity forward, with all other variables held constant, would result in a loss (gain) of \$10 in net earnings before income taxes and minority interest. Any cash paid under the forward contract could be offset by the sale of Loblaw common shares.

Liquidity Risk

Liquidity risk is the risk that the Company cannot meet a demand for cash or fund its obligations as they come due. Liquidity risk also includes the risk of not being able to liquidate assets in a timely manner at a reasonable price.

Should the Company's financial performance and condition deteriorate or downgrades in the Company's credit ratings occur, the Company's ability to obtain funding from external sources may be restricted. In addition, credit and capital markets are subject to inherent global risks that may negatively affect the Company's access and ability to fund its short term and long term debt maturities. The Company mitigates these risks by maintaining appropriate levels of cash and cash equivalents and short term investments, by actively monitoring market conditions and by diversifying its sources of funding and maturity profile.

The following are the undiscounted contractual maturities of significant financial liabilities as at December 31, 2008:

	2009	2010	2011	2012	2013	Thereafter	Total
Interest rate swaps payable ⁽¹⁾	\$ 13	\$ 13	\$ 13	\$ 13	\$ 5		\$ 57
Equity swaps and forwards ⁽²⁾	261	82				\$ 92	435
Long term debt including fixed interest payments ⁽³⁾	742	638	953	257	596	7,650	10,836
Capital securities ⁽⁴⁾	265						265
	\$ 1,281	\$ 733	\$ 966	\$ 270	\$ 601	\$ 7,742	\$ 11,593

(1) Based on the pay fixed interest which will be partially offset by the floating interest received.

(2) Based on the average cost base as at December 31, 2008.

(3) Based on the maturing face values and annual interest for each instrument as well as annual payment obligations for VIEs, mortgages and capital leases.

(4) GWL's capital securities are included as subsequent to year end the Company provided notice to the holders that such securities will be redeemed on April 1, 2009. Loblaw's capital securities have been excluded as Loblaw is not currently contractually obligated to pay these amounts.

The Company's bank indebtedness, short term bank loans and accounts payable and accrued liabilities are short term in nature, and as such are all due within the next 12 months.