

Canada Pension Plan Investment Board.

Special Examination Report
2003-2004

June 15, 2004

**CANADA PENSION PLAN INVESTMENT BOARD
SPECIAL EXAMINATION REPORT
TABLE OF CONTENTS**

A. OBJECTIVES, SCOPE AND CRITERIA	2
B. CONTEXT	3
C. OPINION	4

APPENDICES

A. FOCUS AREAS AND EXAMINATION CRITERIA
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**To: The Minister of Finance, Canada
The Minister of Finance and President of Treasury Board, Government of
Newfoundland and Labrador
The Provincial Treasurer, Government of Prince Edward Island
The Minister of Finance, Government of Nova Scotia
The Minister of Finance, Government of New Brunswick
The Minister of Finance, Government of Ontario
The Minister of Finance, Government of Manitoba
The Minister of Finance, Government of Saskatchewan
The Minister of Finance and Chair of the Treasury Board, Government of Alberta
The Minister of Finance, Government of British Columbia**

A. OBJECTIVES, SCOPE AND CRITERIA

As required by section 47 of the *Canada Pension Plan Investment Board Act* (CPP Investment Board Act), we have carried out a Special Examination of the financial and management control and information systems, and management practices maintained by the Canada Pension Plan Investment Board (CPP Investment Board). The CPP Investment Board is required by paragraphs 39(1)(b) and 39(2)(a) and (c) of the CPP Investment Board Act to maintain these systems and practices in such manner as will provide reasonable assurance that:

- The assets of the CPP Investment Board and those of its subsidiaries are safeguarded and controlled;
- The financial, human and physical resources of the CPP Investment Board and those of its subsidiaries are managed economically and efficiently; and,
- The operations of the CPP Investment Board and those of its subsidiaries are carried out effectively.

Our statutory responsibility is to express an opinion on whether, during the period under examination, which was from January 2004 to March 2004, there was reasonable assurance that there were no significant deficiencies in the systems and practices examined.

A plan for the examination, based on our survey of the CPP Investment Board's systems and practices, was submitted to the Audit Committee on December 3, 2003. The plan included the criteria to be applied in the Special Examination. The criteria were selected specifically for this examination by our team, after consultation with the CPP Investment Board. The criteria were selected based on our knowledge of and experience with the standards and practices followed by the CPP Investment Board and by other organizations, and by reference to legislative and regulatory requirements and to professional literature. The Audit Committee has approved the examination plan and criteria. These criteria are listed in Appendix A.

The plan also identified those systems and practices that we considered to be essential to providing the CPP Investment Board with reasonable assurance with respect to its assets being safeguarded and controlled, its resources being managed economically and efficiently, and its operations being carried out effectively. These systems and practices were selected for detailed examination. Other systems and practices of the CPP Investment Board, although covered in the survey, were excluded from detailed examination because our analysis of the significance and risks associated with them indicated that, during the period under examination,

they were not critical to providing the CPP Investment Board with the reasonable assurance required by 39(1)(b) and 39(2)(a) and (c) of the CPP Investment Board Act.

Our examination was conducted in accordance with the plan, as well as value-for-money auditing standards recommended by the Canadian Institute of Chartered Accountants. Accordingly, it included such tests and other procedures, as we considered necessary in the circumstances. In carrying out the Special Examination, we relied on internal audits conducted by the CPP Investment Board's Internal Auditors during the period from June 2003 to January 2004 to the extent appropriate.

B. CONTEXT

It is recognized that the CPP Investment Board operates in a complex and evolving environment. At the time of the Special Examination, its mandate was (a) to manage any amounts that are transferred to it under section 111 of the *Canada Pension Plan* in the best interests of the contributors and beneficiaries under that Act; and (b) to invest its assets with a view to achieving a maximum rate of return, without undue risk of loss, having regard to the factors that may affect the funding of the Canada Pension Plan and the ability of the Canada Pension Plan to meet its financial obligations. Since commencement of its operations in 1998, the Board has progressively moved through the start-up phase and is currently poised to begin its next period of rapid growth, in preparation for its increased responsibilities. The most significant increased responsibilities are the management of all remaining Canada Pension Plan (CPP) fixed income assets and the provision of cash management services for the CPP. The transfer of the \$30.2 billion in bonds began on May 1, 2004, and will take three years to complete. The transfer of the cash balance (\$7.5 billion as at March 31, 2004) will commence September 2004 and take a year to complete. The provision of cash management services will also begin in September 2004. In response to this changing environment, and within the context of its organizational stage of development, the CPP Investment Board has undertaken a number of significant initiatives focused on investment management and on building its organizational capability.

The CPP Investment Board has developed an investment management team with portfolio management capabilities in both the public and private markets. The CPP Investment Board has created a diversified portfolio within equities in both the public and private equity markets. It has also commenced investing in real estate and, most recently, infrastructure assets.

In order to focus on managing these various asset classes, the CPP Investment Board created sophisticated measures of portfolio risk management, developed the ability to internally manage the equity portfolio passively, and more recently designed a customized global industry sector passive portfolio, to correlate more effectively with the CPP liabilities than do the regional broad market indexes, and adopted equity benchmarks based on the Citigroup global sectors. The organization engaged external transition managers, established internal trading capabilities to assist with the investment of the cash received from the CPP into the passive equity portfolio without disrupting the market and, more recently, implemented an active manager overlay program to generate investment returns in addition to the passive equity portfolio returns.

In preparation for its expanded responsibilities and its move to the next stage of organizational development, the CPP Investment Board has undertaken several initiatives aimed at strengthening its organizational capability. The organization refined its strategic direction in

Fiscal 2004. In addition to modifying its vision and mission statements (within the responsibilities under the CPP Investment Board Act) and articulating its values, the CPP Investment Board identified seven strategic differentiators to drive organizational performance. Organizational design-related work, to accommodate growth projections, has been initiated and the necessary supporting infrastructure is being put in place. In addition, the organization continues to use external service providers as a key component of service delivery. There is a continued focus on principles that promote effective governance, balancing the responsibilities of operating at arm's length from governments with full accountability to Parliament, the provinces and the public.

C. OPINION

In our opinion, with respect to the requirements of section 47 of the CPP Investment Board Act and the criteria applied, there is reasonable assurance that there are no significant deficiencies in the systems and practices in the period of examination from January 2004 to March 2004.

Chartered Accountants

Toronto, Canada
June 15, 2004

APPENDIX A: Focus Areas and Examination Criteria

The six focus areas and their related examination criteria are presented below:

Building organizational capacity to deliver against current and growth mandates - Planning, acquiring, organizing, developing and retaining the resources (<i>e.g. human, financial, technological</i>), competencies (<i>e.g. subject matter and leadership skills including transition capability</i>), processes and scalability to support current and anticipated responsibilities.	
Resources Planning	There is a business plan, which details appropriate resources (<i>e.g. human, financial, technological</i>) to deliver on responsibilities
Appropriate Information Systems	The information systems and processes that support the planning, acquisition and development of resources have the desired functionality, are available, protected, maintainable, and scalable.
Accountability Framework for Effective Operations	There is a link between organizational structure/ design and the accountability framework to ensure effective operations
Change Capacity	There is organizational capability (<i>e.g. plans and processes, infrastructure, skills</i>) to manage transition and change.
Key Person Risk Mitigation Strategy	There is a key person risk mitigation strategy, with appropriate contingency planning
Planning and corporate performance measurement – The process for defining strategic direction, aligning business planning and the development of ongoing measurement and reporting of performance.	
Strategic Direction	There is a strategic direction that is well understood at all levels of the organization
Business Plan Aligned With Strategy	The business plan, including budgeting and forecasting, is aligned with the strategic direction
Departmental Objectives in Support of Strategy	Objectives and initiatives at the departmental level support the strategic direction
Corporate Performance Measurement and Management	A set of performance measures, aligned with corporate and departmental objectives, is used to monitor and manage performance toward achievement of organizational goals
Senior Management - Board Interface	The interface (communication, information, focus) between Senior Management and the Board of Directors enables effective oversight by the Board of Directors
Investment Risk Management – Policies, practices and systems supporting investment risk management, measurement and oversight.	
Risk Identification, Management and Containment	Risks are identified, understood and managed; risk management responsibilities are defined and acknowledged and risk containment includes protection against error or abuse

Risk Measurement Methods	Methods exist to measure risk in a timely, accurate, consistent and understandable manner while considering the limitations of quantitative measures
Independent Compliance Review and Oversight	There is independent review and oversight of compliance, methodologies, models and systems
Information Systems for Investment Risk Management	There are information systems and processes that support the management of investment risk
Management Controls And Compliance With External And Internal Requirements – Identification, assessment, monitoring and reporting on management controls over key corporate processes and key compliance elements.	
Risk Identification Process	The organization identifies key management controls and compliance requirements based on a risk identification process
Adequate Management Controls	The organization assesses the adequacy of management controls
Implementation of, and Adherence to, Controls	The organization monitors the implementation of the management controls and the adherence to the necessary compliance requirements
Reporting of Breaches of Control Requirements	The organization reports on, and escalates breaches of, management controls and compliance requirements
Managing Third Party Relationships – The systems and processes to manage third party relationships including selection, monitoring performance and integration into CPP Investment Board operations.	
Third-Party Relationship Risk Assessment	There is a risk management philosophy to address third party relationships and risk assessment of all proposed and existing third party arrangements
Materiality-based Risk Management of Relationships	The organization monitors and manages risk, based on the materiality of the third party arrangements
Relevant Information Flow to Board	The organization ensures that the Board of Directors receives information related to third party relationships that enables them to discharge their duties
External Communications – Planning, execution and evaluation of external communications to support achievement of the organization's objectives.	
Stakeholder Focused External Communication Strategies	External communication strategies, to fulfill accountability to stakeholders, to build reputation equity, and to manage reputation risk, are based on a good understanding of stakeholder expectations
Planning and Monitoring of Strategy Execution	There is effective planning and monitoring of the execution of communications strategy
Enabling Communication Tactics and Protocols	Communication tactics and protocols support the organization's objectives
Crisis Management	External communication processes and protocols to manage a crisis are well defined and understood