FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
1250 H Street, NW Washington, DC 20005

THRIFT SAVINGS PLAN

January 18, 2011

MEMORANDUM FOR BOARD MEMBERS SAUL, SANCHEZ, DUFFY, KENNEDY, AND BILYEU

FROM: GREG LONG
Executive Director

RE: Minimum Required Distribution Incident Report

TSP participants who are separated are required to receive a Required Minimum Distribution (RMD) each year beginning the year following the year they turn 70 ½. On behalf of participants, the TSP calculates these RMD amounts, processes the distributions, and completes tax reporting. This year, we issued 5,921 correct RMD payments totaling $15.5 million. Unfortunately, we also had an error related to year-end processing of RMDs. The error caused 9,721 participants to receive distribution checks who should not have. The funds disbursed to these participants total just over $58 million. An additional 451 participants whose first year RMD would normally have been issued in March of 2011 were paid early in the year-end cycle. The funds disbursed to these participants total just under $3 million.

Each of the distributions was processed on the night of December 28, sent to Treasury on the morning of December 29 and visible to the participants via the web and phone that same day. The checks were processed by Treasury on December 30. This was the last day in 2010 for disbursements to be included in 2010 tax records due to Treasury being closed for disbursement activity on December 31.

In the following paragraphs we will review several aspects of this incident:

1. How the TSP Processes RMD Transactions
2. Root Cause of Error
3. Response and Communications
4. Factors Contributing to the Error
5. Lesson learned

How the TSP Processes RMD Transactions

In the world of private sector defined contribution plans, the number of participants who are more than 70 ½ years old and remain in the plan after separation is typically small. This enables most plan sponsors to execute RMDs through a manual process. Because of the size of the TSP, a manual process would be prohibitively expensive. Instead, we rely on an automated process to execute these transactions. The logic of this transaction is incorporated into the Omni software that we utilize. The recordkeeping data fields that are components of this transaction are the RMD eligibility date and stored year-end balances for participants aged 69 or older. When a participant has a current RMD eligibility date and a stored year-end balance, a RMD transaction is initiated.

Root Cause

The root cause of the error is related to the implementation of spousal Beneficiary Participant Accounts (BPA). This is the new feature made possible by the TSP Enhancement Act of 2009 which permits the creation of a TSP account for the surviving beneficiary of a deceased TSP participant. A beneficiary participant may be subject to the RMD rules but this determination is dependent on the age of the (now deceased) participant at date of death. We created new software code to calculate the date that a BPA participant would be eligible for a RMD and to populate the proper field with this date. This change, which created an automated process for executing RMD transactions for beneficiary participants, was improperly coded. The code erroneously changed RMD eligibility dates for many active participants in the recordkeeping system. When this date was matched with a positive value in stored year end balance for participants age 69 and older, a RMD transaction was initiated. Thus, all participants who received a RMD check were at least 69 years old. The vast majority of the participants who received incorrect payments are not subject to the IRS minimum distribution rules because they are still actively employed by the Federal Government.

Response and Communication

We became aware of the error on December 29 when participants seeing the erroneous transaction phoned the call center. We discussed options of attempting to pull the file back from Treasury before they processed and mailed the checks. I rejected that option because that would have meant that all legitimate withdrawal and loan payments would not occur in the 2010 tax year. As these are Treasury checks, individual stop payment actions were not possible. We therefore moved to develop response and communications plans.

To remedy the error, we decided to notify all affected participants, offer to take the funds back, and when received, restore the account by adjusting for all investment earnings or losses. This remedy would return the account value to where it would have been had the erroneous distribution not occurred. We also advised the affected participants of the tax impact of not returning the funds.

The phone centers were provided with these instructions on December 29 and by December 30 a note was added to participant service representative (PSR) system. By the close of the first week of January explanatory letters were in the mail and posted to the online account of each affected participant. Through the press, we presented these same messages in print and radio media that are widely followed by Federal employees. The information was also provided to TSP coordinators at Federal agencies and to the Department of Labor.

Operationally, this error created significant workload. The communication team allocated resources to drafting notices and responding to inquiries. The phone center volumes spiked in the first week of January after the erroneous checks were sent and the issue was discussed in the media. The automated systems team has created and executed multiple system change requests. Thus far, over 4,400 returned checks have been processed.

Factors Contributing to the Error

Each December we perform a test run of year end production. A report provided by our vendor on December 18 showed an estimated distribution of over 16,000 RMD payments. This number far exceeds the approximately 6,000 legitimate 2010 RMD payments. We failed to recognize that the figure of 16,000 RMD payments was inappropriately large. We relied on institutional knowledge to judge the reasonability of these numbers and have not previously applied a formal test of tolerances-against-trend test. Even if we had a formal trend analysis in place it would have been challenging to recognize given that the 2009 RMD rules were waived as part of the Worker, Retiree and Employer Recovery Act of 2008. As part of planning for the year-end production, we tested the functionality of the RMD eligibility date, year-end balances and RMD calculation. Each process was tested with a sample group of accounts, found to be free of defects and working properly individually.

We have made enhancements to our software code writing quality control and front-end testing, but clearly greater enhancements are needed. We now test all changes made to the software in order to find defects before new code enters production using manual testing and evaluation procedures. We tested the code changes to the BPA eligibility date and determined that it had the intended effect on beneficiary participants. However, we do not currently have the capability to perform an automated test in a full production sized integrated test database that would test all changes together on all accounts and run automated reviews of the results. In short, each piece of code had the intended effect on the group of participants that it was targeting. However, the BPA related code had an unintended effect on regular participants that we failed to detect in testing.

The year-end production cycle is always a complex and labor intensive exercise. This was further complicated this year by the introduction of a significant amount of new code development and testing associated with spouse beneficiary participant accounts, which introduced a conflicting software code result in the form of the error addressed in this memorandum. Our development and testing resources also were heavily focused on new code to retire the L2010 Fund on December 31. Additionally, in executing the year-end production run on the last business day of the year for 2010 tax reporting, we effectively foreclosed the opportunity to complete back-end testing in time to correct the error we discovered on December 29. FRTIB employees and our vendor partners went to great lengths to achieve accurate results within the required deadlines. In the course of those efforts, we made a mistake.

Lessons Learned

This error and the lessons we learn from it will result in changes to our procedures, resources and plans for 2011 and beyond. Our lessons learned include:

1. Institutional knowledge is an important but imperfect tool for detecting defects. We must better formalize this process by identifying year-end test run expectations at a more granular level and build project timelines to include adequate time to perform formal comprehensive review and data acceptance among users and subject matter experts.

2. The year-end process is already complex. Do not complicate it further by instituting significant system changes in December, unless absolutely necessary. This lesson directly applies to the planned launch of Roth in early 2012.

3. In an effort to reduce the 2011 budget by $760,000, and a similar expense in 2012, I offered to delay the purchase and implementation of automated testing tools and creation of a full-sized integrated test file set. This management prioritization decision should be revisited before we implement Roth or any other significant system change.

4. Leave time for emergency corrections to the year-end processing cycle. By processing RMDs earlier in December, we can create time to perform back-end testing and correct any errors. However, such action has other business impact that needs to be considered.

5. Expedite efforts to collect, maintain and use participant e-mail addresses and targeted web messages in affected participant accounts for post-event communication. This could have substantially reduced calls to the call-centers.