Pearl Meyer

TRENDS & ISSUES

Healthcare Executive Pay: Top Five Trends for 2018

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Change is the only constant when it comes to the healthcare industry. Many had hoped for some clear direction with regard to healthcare reform in 2017 that didn't materialize, and as we kick off 2018, proposed large-scale mergers such as Aetna and CVS offer the potential for new, further disruption.

Nevertheless, the industry has proven adept at moving ahead with transformation strategies in the face of uncertainty. The view that executive compensation (and particularly the use of long-term incentives) can be a tool to enact strategic business changes is taking hold, and boards of directors are rising to the challenge of guiding their organizations in entirely new directions.

As we look at the unique challenges this industry poses for board governance and executive compensation, there are five key areas to watch in the coming year:

- Alignment of funding models and long-term incentives
- Understanding the insurers' approach to incentive compensation
- Managing compensation for mergers and acquisitions
- Keeping an eye on culture
- Maturing board governance

1. Alignment of Funding Models and Long-Term Incentives (LTI)

While debate continues on healthcare reform, there is little disagreement that there will be continued reduction of funding for Medicare and Medicaid. Provider organizations whose patients are more reliant on these programs are already challenged to provide their boards with operating budgets above break-even.

Healthcare providers serving patient populations with a mix of employer-provided and commercial insurance plans are also feeling the pinch. However, they can more often generate some sustainable margin that can be invested in new or expanded lines of business with more favorable anticipated reimbursement rates, such as ambulatory care, behavioral health, partnerships with other types of providers, enabling bundled services, etc.

It’s in this tough budget environment that all healthcare providers, regardless of their place on the reimbursement continuum, have a common need to recruit, motivate, and retain quality leaders from among a limited pool of candidates.

Given the complexity and long-range nature of healthcare business strategies, there have been two noticeable changes to traditional executive compensation practices in the industry: 1) a greater reliance on variable compensation and 2) an emphasis on long-term incentive (LTI) plans. Boards are finding that LTIs can enable them to more broadly recruit senior executive talent, can provide a retention vehicle for successful executives, and when properly designed, can drive meaningful improvements to the new “triple aim” strategy of improved efficiency, quality, and patient experience. However, to be most effective, these long-term incentive plans may need to emphasize one factor over another, as determined by the organization’s primary reimbursement.

Those hospitals and healthcare systems more reliant on Medicare and Medicaid are quite often “safety-net” providers in the community and are not necessarily challenged by the need to grow market share as much as the need to evolve more efficient and effective ways of treating the flow of severe, often chronic cases they encounter on a daily basis. Their long-term incentives may emphasize driving cost out the delivery system, while demonstrating levels of quality sufficient to maintain their reimbursement eligibility against CMS-mandated (Centers for Medicare and Medicaid Services) thresholds. They must also address patient experience, and may choose to also establish a normative patient rating program, possibly as a factor in the annual incentive, or as another long-term metric or plan modifier.

The strategy of many providers whose current and prospective patient populations are more likely to participate in commercial health insurance plans is to grow that patient demographic and market share. Critical to that goal is the organization’s ability to demonstrate extremely high levels of clinical quality and patient satisfaction over a sustained period of time. As in many industries, achieving consistent high quality in direct care requires that it be built into the core culture of the organization, which is a multi-year proposition.

These organizations may establish long-term incentives driven by some mix of growth and clinical quality, so that their ability to increase either of the two can increase the other. They may also focus on overall patient satisfaction. Since they must also address efficiency to preserve their ability to invest in growth opportunities, they may choose to also establish some measure of operating margin or earnings as a funding mechanism for the overall incentive program.

2. Understanding the Insurers' Approach to Incentive Compensation

The Affordable Care Act (ACA) may have magnified tensions between healthcare providers and health insurance companies, but the ACA has also pushed these organizations toward common goals, such as ensuring high quality treatment for their patients/customers in a cost-effective manner and furthering the health of the communities they serve. Providers and insurers share similar challenges in the design of their executive compensation programs. Two of the common points from a health insurance perspective are discussed below.

Labor market for executive talent

While providers and insurers face similar challenges in identifying and hiring high quality executive talent, the labor market for health insurance companies is quite broad—national in scope and often encompassing not just other health insurance companies but also executives from companies outside the healthcare industry. Compensation committees therefore need to have a solid understanding of this broad labor market and the differences in pay practices among companies across different industries.

Further complicating the picture, much as it does in the provider space, is the combination of not-for-profit and for-profit publicly-traded companies in the health insurance industry. Pay practices for not-for-profits exclude equity compensation, while for-profit publicly-traded companies almost always include equity in their executive pay programs. It's incumbent that not-for-profit boards understand the magnitude of these differences and design their compensation packages accordingly, perhaps incorporating elements such as cash-based long-term incentives and supplemental executive retirement benefit programs (SERPs), to at least partially offset the differences.

Performance measurement in an uncertain environment

Given uncertainties around the future of healthcare reform, compensation committees of health insurance companies have been challenged to identify performance measures for their executive incentive plans. This challenge is particularly acute for insurers who use LTIs in their programs as they need to identify performance measures and goals which will remain relevant over a multi-year time period.

Among publicly-traded insurers, the measures in both annual and long-term incentive plans tend to focus on a balance among profitability, quality, and membership criteria. Long-term incentive plans usually pay out in equity based on the achievement of financial goals and these measures have not really changed since the ACA went into effect.

However, with the passage of the ACA, many insurers have also adopted business strategies which incorporate diversification—both geographic and in terms of the products and services offered—to mitigate the negative impacts of the ACA on their financial results and enable them to continue to provide high quality products and services to their customers. Given the importance of these extended business strategies, many pay programs are including performance measurement that supports these developing strategies and rewards the executive team for successful achievements in these areas.

Among nonprofit insurers, short-term incentives incorporate financial and strategic measures similar to publicly-traded insurers but also focus more heavily on membership growth, quality, and member satisfaction. Long-term incentives at nonprofit insurers are cash-based and focus on broad financial measures. They may also include initiatives to further the delivery of quality healthcare in their coverage areas and/or measures which reflect the successful achievement of diversification and growth strategies. The diversification-related metrics are new with the ACA. Initial performance measures reflecting growth strategies are typically more action-based than outcome-based, with the intention of transitioning more to outcome-based measures over the longer-term as the business strategy becomes more well-defined and potential performance outcomes become less uncertain.

3. Managing Compensation for Mergers and Acquisitions (M&A)

Over the last several years, the healthcare industry has experienced a high rate of M&A activity across for- and not-for-profits and across traditional industry sectors, such as healthcare systems acquiring health plans and vice versa. Now, the proposed Aetna/CVS merger brings a pharmacy powerhouse into the mix.

As boards continue to oversee complicated M&As, among the critical first steps is to determine how executive compensation will be managed over the short- and long-term. The basis for shaping these decisions over the long-term should be the combined organization’s overall strategy, including the objectives associated with the transaction. But there are critical short-term issues the board will need to address right away at the outset of any new M&A activity:

- **Retention:** Move quickly to identify those key leaders whose retention is critical, be it for short-term transitional issues or for the impact they can have over the longer-term. Determine whether there is need for a retention incentive for select leaders. Careful consideration should be given to the degree of selectivity, the retention period(s), and whether performance hurdles are included.

- **Incentive Plans:** Most transactions seek to create operational, strategic, and financial value. This often includes the pursuit of economies of scale and the ability to decrease unit costs or improve productivity, while increasing the quality of care and wellness in the communities served. Incentive plans need to be reviewed to ensure alignment with desired outcomes and should be flexible enough to recognize and accommodate potential changes to the ACA and future reimbursement models. These factors speak to the likelihood that the board may need to exercise discretion in assessing performance.

- **Communications and Culture:** In a period of change and instability (perceived or real), executives will look for signals from the board as to what the future holds. Decisions about compensation send messages about what the organization values and how the cultures of the legacy entities will be impacted, and these decisions impact how the executives see themselves fitting in. Care and clarity on how changes are communicated is critical.

While the board tackles these near-term issues, it must do so in the context of the longer-term business strategy. Some questions to consider include:

- To what extent should the executive compensation programs be driven by the acquiring organization's current practices?
- Are these programs in concert with the goals of the transaction, immediately and over time?
- How can pay programs be optimized to support these short- and long-term goals and send desired messages to the executive team?
- Does the transaction impact how competitive labor markets and competitive positioning are defined?

These questions will help the new entity in an assessment of its overall executive compensation philosophy.

4. Keeping an Eye on Culture

Given all of the various corporate scandals over the last few years and the recent acceleration of these events, corporate culture is fast becoming a top board priority. It's one area where the boards of healthcare providers and insurance companies are *not* in a particularly unique position, but can and should learn from others' missteps.

Historically, culture has not been seen as a major issue as long as company performance is strong. When it's not, cultural issues tend to bubble up more frequently. And while many believe that the CEO "owns" and is ultimately responsible for the culture of the company, the board has the critical responsibility of overseeing that culture and assessing whether it's aligned with the business strategy and values—at all points along the organization's business cycle.

The board also has a responsibility for risk mitigation and that increasingly includes cultural issues, such as questionable business practices; harassment claims by employees, customers, or suppliers; turnover in senior management; and M&A activity where cultures may differ or even clash. Within each of these scenarios, there are compensation implications that the board can and should evaluate. Further, boards should broadly assess the corporate culture, determine its appropriateness for the organization, and hold everyone accountable for actions that don't align.

Some ways a healthcare board can assess the health of the culture include:

- Review results of employee engagement surveys relative to historical and peer company results, and read through employee comments for any red flags
- Observe CEO interactions with his/her direct reports and other senior executives in board meetings and observe comments or behaviors that don't add up
- Take the opportunity to interact informally with executives and other employees, perhaps at pre- or post-board meeting dinners or receptions
- Hold one-on-one meetings with the CEO's direct reports as opportunities arise, and ask questions about the CEO's management style
- Review voluntary turnover rates, and in particular turnover of high performers and high potential individuals, and ask to see exit interview feedback

Recognizing that it can take several years to change a corporate culture, boards can take the following actions to drive and reinforce cultural change:

- Require the CEO to articulate the corporate culture and how it aligns with the company's strategy and values
- Assess the culture annually—perhaps during the annual strategic planning process—and ensure that it aligns with the business strategy
- Assess CEO performance within the context of corporate culture and require other business leaders to do the same with their direct reports
- Oversee the hiring and promotion of senior leaders whose values and behaviors match the desired corporate culture, as evidenced by their past experiences and interactions with others
- Ensure that the performance management process for all employees includes an assessment of the degree to which corporate values and culture are exhibited
- Regularly assess turnover data and performance results, and modify HR policies and programs to eliminate unintended consequences
- Require an external review of the company's incentive programs to determine whether they reward for poor behaviors or excessive risk-taking
- Set up mentoring relationships between board members and members of senior management to create direct channels of communication
- Implement balanced compensation programs:
  - Short- and long-term performance
  - Financial and operational results
  - "The what" and "the how" (e.g., leadership behaviors)
  - Negative discretion if "the how" is not consistent with the culture

This trend appears to have a long trajectory and healthcare boards need to be immediate and proactive about overseeing corporate culture—just as they are with other aspects of the company's performance—to ensure that performance goals are achieved only within the context of the desired culture.

5. Maturing Board Governance—Transparency and Teamwork

Providing effective governance is the key responsibility for any board of directors. In most industries, for-profit directors typically have experience with the type of company on whose board they serve and their background allows productive engagement in their fiduciary and strategic responsibilities. On the other hand, boards of non-profit organizations are often comprised of successful local executives, business owners, and civic leaders who may or may not have direct experience in public company governance or the organization's mission, but their networks and leadership capabilities serve those institutions well.

Boards in the healthcare industry, however, may or may not fit either of these norms and regardless of their experience, may be struggling to provide proper oversight because of the unique challenges of the industry, such as quickly evolving business strategies, emerging practices in executive compensation, and uncertain or inconsistent funding scenarios.

As an example, consider that industry veterans are now often appointed to for-profit healthcare boards due to their expertise in adjacent industries like insurance, hospitality, or retail, as those new skills are now needed in the healthcare space, but they may lack medical or healthcare administrative experience. Another scenario can include not-for-profit directors, who, because they are typically stewards of taxpayer or charity dollars, may have a rightly-held predisposition to very conservative budgeting. While a benefit in most non-profits, that experience could have the unintended consequence of holding up the investment in and advancement of needed new strategies.

Today's healthcare CEO—who increasingly brings a strong mix of medical and administrative acumen to the job—can play a large role in helping the board help the organization. Likewise, the board may bring the business and financial insight that can help management make better informed key strategic decisions. Both sides' abilities to participate in a meaningful dialogue will only improve with knowledge gained from the other.

To the extent that the board can establish an environment of trust with their CEO, he or she may feel more comfortable providing some valuable education regarding shifting payer and delivery of care issues and the organization's strategic initiatives that are in place to address myriad financial, quality, and patient experience challenges. Transparency concerning these challenges, and the organization's chances of success, will only occur when management believes there will be benefit to educating directors and when the board is open to learning and applying medical and healthcare administrative knowledge to their business or non-profit management experience.

As boards recruit new directors or trustees, they should understand if there are missing skills or talents, in addition to evaluating candidates against some important broad factors:

- **Passion**: An ideal director will be passionate about the mission and purpose of the organization which they serve.
- **Diversity**: It's become increasingly important for senior management teams and boards to have a range of points of view in order to best navigate complex issues and best serve varied populations.
- **Experience**: Significant leadership experience tends to mold the most effective board members.
- **Executive/Professional Skills**: It's vital for boards to have a few individuals who have specific skills and experiences to guide complex legal, financial or business issues. Some of the most critical skills are finance, accounting, audit, risk, marketing, IT, HR, and legal.
- **Availability**: An ideal board member will be able to make a serious time commitment to actively participate in both board and committee level work, including meeting preparation and attendance, as well as special projects/initiatives throughout the year.

The changing skill sets required for effective oversight in the industry point to a related consideration for healthcare boards: compensating their directors, which is a common practice among not-for-profit and for-profit insurers but is uncommon among not-for-profit providers. Across all industries, there has been a steady increase in the time commitment and amount of activity and strategic work that is needed at the full board and committee levels.

Correlating with the demand for top-level talent and the director's workload is the need to ensure that board compensation programs for those that do pay their directors are competitive with the market. Both not-for-profit and for-profit healthcare organizations which pay their boards conduct periodic assessments of board compensation relative to other similar organizations and make adjustments as needed to ensure they can continue to attract and retain high quality director talent with the backgrounds and experiences that the board may require.

Looking Forward

While stability and predictability in the industry may not yet be in sight, providers and insurers are adapting to the realities of an uncertain healthcare environment. As they seek out new strategies and tools to manage the business of healthcare, executive and board compensation programs can have an increasingly influential role to play in this transformation.

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About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Jose.

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