Looking Ahead: Top 5 Compensation Committee Issues Facing Healthcare in 2015

By Steve Sullivan and Jim Hudner

Most healthcare executives will be focused on increasing efficiency in 2015. Despite an overall economic upswing, controlling costs has never been more critical, or more challenging. How will providers reduce the cost of treating patients as they employ more physicians at higher charge rates, move toward increased clinical integration, experience reduced reimbursement levels and pay more for high-cost drugs, all while implementing new delivery models and paying for significant upgrades to healthcare information technology?

As executive teams expand to include expertise in clinical integration, insurance risk and overall customer experience, their required experience begins to resemble the C-suites in other industries. Executive compensation in healthcare is at a crossroad and Compensation Committees need to quickly assess their overall approach and identify winning processes from other industries that can successfully drive these major shifts in the business of healthcare.

We believe healthcare Compensation Committees face five key issues in 2015:

1) Managing complex business strategies and the impact on compensation;
2) Identifying appropriate variable compensation measures and metrics;
3) Recruiting and retaining executive talent from other industries;
4) Using discretion when evaluating performance against plan; and
5) Determining Board pay for non-profit healthcare Directors.

Here we discuss practical and effective approaches to addressing each of these major challenges as they relate to independent hospitals and healthcare systems.

1) Managing Complex Business Strategies and the Impact on Compensation

The Affordable Care Act (ACA) continues to push provider organizations to establish tighter payer-provider contractual arrangements as a way to contain the growing financial risks and responsibilities associated with the costs of care and outcomes. While these more stringent arrangements may prove to be financially beneficial over time for insurers, providers and ultimately patients, in the near-term they require health systems and hospitals to:

- Price, position, and promote risk-managed insurance;
- Upgrade capacity for data analytics;
- Achieve physician-led clinical integration;
- Anticipate and control costs; and
- Develop population health strategies and metrics.

This is a tall order. Are the U.S. healthcare executives being asked to drive these strategic changes properly incented to be successful? Quite often there is a considerable gap between these critical initiatives and the specific metrics found in executive compensation programs.

Forty-three percent of the 428 U.S. healthcare executives sampled in a November, 2014 study[1] said that their organization has not modified executive compensation incentives to reflect the value-based purchasing transformation now underway.

The unprecedented nature of this strategic and fundamental transformation requires major changes to the design, delivery, criticality, competitive positioning and communication of executive compensation.

Align business strategy and compensation program design.
Most provider organizations must continue to deliver on the current model of specific fee-for-service criteria in order to be reimbursed today, while they are simultaneously engaged in establishing these new, much more complex and long-term practices. The selection of measures and metrics within short- and long-term incentive arrangements similarly should validate new targeted organizational performance and traditional goals.

Consider expanding incentive plan eligibility to upper and middle management.
The extent to which a hospital or healthcare system can turn on a dime and move in a new direction will likely be a result of what occurs "in the trenches." The leadership team can articulate the plan for executing on specific initiatives, but it very likely will be Tier 4 and 5 managers responsible for the bulk of the heavy lifting that's required for success. This group's pay-for-performance opportunity should closely align with that of the executive leaders.

Increase the portion of total compensation delivered through incentive awards.
The C-Suite now has a much greater capacity to impact organizational results than ever before, therefore the variable portion of its pay-for-performance equation should be larger. Target award levels moving from 5 to 15% of base salary to 30 to 50% can act as an effective tool to drive desired outcomes. It's important to note, however, that these dramatic changes require extremely sound and reliable measures and metrics, and often prewritten and approved policies around Board discretion, which we will address in more detail.

Move to a more corporate model and consider longer-term incentive arrangements.
Boards must adopt a strategic long-range view of their organizations as most of the transformative changes in the industry will require years to accomplish and even longer to properly gauge success. Multi-year incentive plans can balance the executive team's immediate operational focus with a strategic view of how they can drive long-range enterprise value.

Elevate the understanding of executive and management incentive opportunities.
In the wake of a significantly altered compensation philosophy, it's critical to include a solid communication plan that clearly outlines variable compensation arrangements, the reasoning for such plans and how they are based on business strategy, and the metrics that will be used to gauge success.

[1] The 2014 Executive Compensation Survey, conducted by the HealthLeaders Media Intelligence Unit

2) Identifying Appropriate Variable Compensation Measures and Metrics

Even with carefully aligned strategy and compensation plan design, a Board's efforts can unfortunately fail unless incentive plan performance measures and metrics are properly identified and performance against those measures is properly assessed.

Incentive plan measures should relate directly to strategic objectives.
The Compensation Committee should select measures that relate directly to the overall strategy of the organization. While overused, the old adage "you get what you pay for" has definite meaning. If incentive award opportunities are contingent on performance against any goals other than those very specific goals that drive the strategic plan, the organization may progress in an unintended or unfocused direction.

Create a balance between lead and lag performance measures.
Many of the metrics used in healthcare are lag measures, reflecting what has happened. This information is important to know, quantify and act upon. However, organizations that are undergoing wholesale change should establish a balance between the historical lag goals and critical lead measures, such as new program development or enrollment in risk-managed insurance plans. These performance measures can show if the organization is on the right path directionally and allow leadership to re-tool planning as needed.

Incentive plan performance measures should have some relevance to the performance of other healthcare organizations.
Relative Total Shareholder Return ("TSR") is now the most prevalent measure used to evaluate public company performance for incentive awards as it allows direct comparisons with competitor companies. Similarly, healthcare has embraced measurements such as Standard & Poor's bond ratings, Press-Ganey, HEDIS and HCAHPS, as they allow relative comparisons of performance against other providers of the same size or discipline, in the same city, state, region, etc.

An organization's performance against its own targeted operating margin or its own readmission goal only allows an absolute comparison and makes it difficult to quantify success against competitors. As providers seek to measure new elements like care access, physician engagement and population health, the Committee may in the short-term need to establish some of these as absolute measures until a critical mass of similarly-situated healthcare organizations seek the same data and then relative performance can be more accurately assessed.

Establish corporate-wide and team-based goals.
Executives will need to work collectively in the new value-based industry environment. Changing the business of healthcare will require sharing information, collaborating on execution and maintaining solid and consistent communication among groups throughout the organization. It's important to begin shifting from individual goals, moving those to individual performance management programs, while developing broader goals and measures for compensation purposes that are team-based.

Keep it all straightforward, attainable and measurable.
Goals that are not clear are not easy to achieve. Each incentive plan measure should describe exactly the factor being measured and assessing results should not require complex mathematical or statistical formulae. Targeted levels of performance should be associated with at least a 50% likelihood of achievement, especially during early phases of a long-term plan, allowing participants a solid opportunity for success that can build toward the goal in succeeding years. The precise metrics identified for each incentive measure should allow easy quantification of performance against target.

3) Recruiting and Retaining Executive Talent from Other Industries

The changing strategic focus in healthcare is creating new leadership positions and new ways of looking at and for the executive skills that are now required for success. Physicians in the C-suite, retail and hospitality executives operating within a healthcare facility and greater crossover between providers and insurers represent some of the influx of varied talent we are already beginning to see in response to healthcare reform.

The retail-like influence is already emerging and provides one example. Relatively quickly, companies such as CVS and Walgreens have entered the patient care arena with products like Minute Clinic at a time when traditional healthcare provider organizations continue building their own franchises of neighborhood wellness and ambulatory care centers. As the two types of organizations compete for the same customers, providers may begin to look to retailers as a great source of executive-level, consumer-oriented expertise. In fact, many providers have already made patient experience a strategic goal and some have even hired a Chief Experience Officer to impact the look and feel of all patient programs. As reimbursement levels will now be dependent upon not only outcomes, but also on patient satisfaction, many healthcare providers are looking to the retail and hospitality industries as a path to success and need leadership in these non-traditional areas.

Even clinical roles are morphing in reaction to industry changes and requiring additional skill sets. In "Building a Leadership Team for the Health Care Organization of the Future"[2], the Chief Medical Officer (CMO) who has been historically responsible for medical staff management is "now more operational and strategic, focusing on quality and efficiency targets, strategic planning, partnerships, long-range forecasting and decision analysis."

While the CMO continues to be a physician executive, the skills necessary to succeed in that role now include those once left to non-clinical administrators, such as the ability to predict, plan and drive the organization's healthcare strategy toward not just healing the sick, but also broader community health. In the wake of healthcare reform, clinical attributes must be integrated and converted into operational decisions. This demands an expertise that can often be found in adjacent industries.

While in the future we may see better food, more comfortable hospital stays, and user-friendly service touch points as a result, from a business perspective, this kind of mandated strategy shift means heathcare providers and thus executives are having to move far outside their traditional roles. This expansion of skills – and in some cases completely new required skill-sets – places a hefty burden on Compensation Committees. They must not only develop base, short- and long-term pay programs that can enable recruitment of the non-traditional healthcare executive, but must balance pay with the current slate of executives whose valuable clinical skills must also be retained.

[2] Spencer Stuart and Hospital Research and Education Trust

4) Using Discretion when Evaluating Performance Against Plan

There is increased attention to the use of discretion by Compensation Committees in assessing executive performance and incentive awards. Critics suggest there should be simple, straightforward accountability for performance measures as defined by the Board. They charge that to add a subjective element taints the clear relationship between pay and performance. Some also assert that Board discretion tends to only be used to positively impact executive award levels.

Why board discretion is appropriate.
In most industry sectors, the ability to define annual goals, let alone long-term goals, has become an increasing challenge. The fast and widespread shifts of a global economy, changes in the regulatory landscape and the continued explosion of technology – both its benefits and its complications – can wreak havoc on goal setting and assessment. Healthcare is in a period of profound change and faces many unique pressures in addition to these universal difficulties.

While the notion of linking executive pay to predefined performance metrics is sound – and there should obviously be a strong relationship between performance and pay – Boards should not be required to use only a rigid assessment of performance. The changes happening in the business of healthcare are dramatic and complex and the identification of appropriate performance measures and targets will continue to evolve.

The most prevalent form of incentives in healthcare today are annual plans and while long-term plans exist, there are challenges due to the lack of equity and the current lack of familiarity most healthcare Boards have in their use. With greater use of short-term plans, it is critical that the pursuit of short-term goals is not at the expense of the longer-term objectives that are going to be critical to success in the new competitive landscape. As healthcare organizations begin to utilize more long-term incentives as a tool to drive change, there will be an even be greater need for the use of discretion to properly interpret performance against plan.

How discretion should be used.
The application of discretion should not be a surprise. The key is defining the parameters and processes in its application. A fundamental parameter is the extent to which discretion can be applied. For instance, the Board may want to define a specific percentage that represents the maximum level of discretion (upward or downward) it is able to use. It may also be helpful to identify in advance those factors that could impact the appropriateness of defined performance measures, for example broader economic conditions. There also should be clarity on those areas of performance for which an assessment will by necessity include some subjective judgment, such as “improved Board relationships.” Greater clarity up front all but ensures there will be more trust by management of the Board’s judgments.

As the year unfolds, the Board should be assessing progress on key performance objectives, significant and unanticipated changes in the external environment and the extent to which there are any changes in short-term priorities, such as an unexpected acquisition. Open and frequent discussions between the Board and management are certainly necessary from a general governance perspective, but additionally they serve as a basis for ongoing feedback which can help set the stage for the Board’s overall evaluation of performance and potential use of discretion.

Finally, the Board should clearly document its rationale for any discretion, take great care in being consistent from year to year in how it is applied, and monitor how it has been used over time. For instance, if there are four straight years of positive discretion (adjusting awards upward), this

should be a signal to review the goal-setting process, as well as the Board's process for using discretion.

In the end, a clear plan, open and ongoing communication and the use of sound business judgment will form the basis for an appropriate – and often necessary – use of Board discretion on incentive awards.

5) Determining Board Pay for Non-Profit Healthcare Directors

As healthcare organizations respond to the changing marketplace, become more complex and, in many cases, consolidate and become larger, the demands on Boards and the talent needed becomes an issue just as it is with executives. Further complicating the issue in the healthcare industry is the prevalence of not-for-profit entities.

Compensation for not-for-profit Board service in healthcare is currently an unusual practice with only 17.5% of these healthcare provider Boards offering Director compensation[3]. However, many large, complex not-for-profit organizations are beginning to reconsider their long-term position on volunteer Board members. There are many nuances for both the organization and the individual Board member as they review this decision.

One of the biggest issues considered by individuals being asked to sit on any Board is the liability exposure and the nature of the healthcare business which makes this particularly relevant. Many states have adopted non-profit corporation codes that protect unpaid Directors against personal liability for actions taken on behalf of the organization. From an individual standpoint, this removes one of the biggest obstacles to sitting on a Board, and may make the idea of a paid directorship less critical. There are also other considerations important to many non-paid not-for-profit Board candidates that may override payment including:

- Giving back to the community;
- Expanding professional and personal networks; and
- Community esteem.

These considerations alone may attract many strong candidates to a not-for-profit Board of Directors, and in some cases may be at odds philosophically with the idea of receiving compensation for services.

Interestingly, the arguments in favor of payment are often more important to the organization then to the individual. This is likely to become a growing consideration as Boards will be expected to deliver more complex and strategic guidance. Providing pay for Board members can change the way they approach their service and potentially have positive impact on the strategic changes that must be driven through the organization. Specifically, paid Directorships:

- Promote professionalism over amateurism;
- Attract the most qualified candidates;
- Enhance meeting attendance; and
- Create accountability for performance.

In this context, another issue for consideration is continued focus by the Attorney General in several states threatening to partner with their state legislatures to broadly limit or eliminate compensation to not-for-profit organizations' Directors.

[3] The 2013 Governance Institute Survey of Healthcare Providers

In Summary

It's clearly a significant period of change in the healthcare industry, complicated by intersecting demands from stakeholders, non-profit missions, government and the entire general population. While it will be a daunting task to move the industry in a new direction, it will not be without reward for those organizations who take a careful, measured and strategic approach to achieving new goals and who are able to leverage every tool at their disposal. Boards have an opportunity to provide solid direction by borrowing from other industries, recruiting the appropriate talent and using compensation as a driver of change.

We will continue to keep a finger on the pulse of the industry and the evolving trends where compensation can be an effective tool and we welcome the opportunity to provide guidance for your organization.

About the Authors

Steve Sullivan, a Vice President with Pearl Meyer & Partners' Houston office, has over 20 years of consulting and industry experience assisting clients in executing their strategic human resources and compensation initiatives. His focus has been in the areas of executive compensation program benchmarking, design and oversight in the healthcare industry. Mr. Sullivan also advises clients in the areas of sales and performance incentives, recruitment, motivation and retention, strategic compensation program design and implementation, and organizational change.

Jim Hudner is a Managing Director in the Boston office and has advised clients for over 20 years in total compensation strategy, compensation planning, base salary management, incentive plan design, executive compensation and performance management. He has expertise in developing integrated compensation programs in support of mergers and acquisitions, and has worked extensively with organizations in financial services, higher education and healthcare.

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Pearl Meyer & Partners
Comprehensive Compensation®

www.pearlmeyer.com

NEW YORK
570 Lexington Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA
One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON
132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
123 N. Wacker Drive, Suite 860
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LONDON
Clifford House
15 Clifford Street
London W1S 4JY
+44 (0)20 3384 6711
london@pearlmeyer.com

LOS ANGELES
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

SAN FRANCISCO
595 Market Street, Suite 1340
San Francisco, CA 94105
(415) 651-4560
sanfrancisco@pearlmeyer.com

SAN JOSE
2880 Zanker Road, Suite 203
San Jose, CA 95134
(408) 954-7399
sanjose@pearlmeyer.com