Pearl Meyer

TRENDS & ISSUES

The Top Five Healthcare Executive Compensation Trends in 2019

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The healthcare industry has had no shortage of upheaval and sizeable business challenges. As we prepare to weather a new round of political debate and shifting alliances among the largest players, boards and management teams must press on in their transformation journey and carefully consider all possible avenues for financial stability and a competitive edge.

It's in this context we offer our annual look at the most current and pressing areas for healthcare organizations where compensation may play a significant role. We believe many boards are or soon will be talking about:

- Managing the disruption in access to care;
- Retaining key executives;
- Balancing intrinsic and extrinsic motivation;
- Addressing gender pay issues; and
- Expanding the scope of the compensation committee

Managing the Disruption in Access to Care

Many different types of companies are now entering the healthcare marketplace and disrupting medicine's traditional delivery channels by focusing directly on healthcare consumers. We outline some recent examples and their expected impacts, as well as the challenge these changes pose for compensation committees in the healthcare space.

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- CVS acquired Aetna to “remove barriers to high quality care.”
- Walgreens and Microsoft are partnering to provide immediate connectivity between consumers, providers, pharmaceutical manufacturers, and payers.
- Anthem is partnering with Walmart to deliver a new and convenient Medicaid program.
- Humana and Walmart have established the Humana Walmart Prescription Drug Plan.
- Amazon, Berkshire Hathaway, and JPMorgan Chase are partnering to “enable improved quality and overall transparency and speed within the healthcare sector.”

These collaborations between retail, finance, technology, and insurance companies constitute true disruptive innovation and will upend the way individuals and families encounter immediate and primary care, as well as obtain and pay for prescriptions. Patients’ waiting time to access medical care is a prime example. “Access to Care” measurements continue to be critically important to providers for care quality and reimbursement and often appear in a healthcare executive’s incentive compensation program. Traditionally those leaders able to drive down the number of days or weeks between a patient requesting an appointment and seeing a physician were rewarded with some portion of an incentive award. These new disruptive partnerships are already changing the conversation from days to hours and minutes. More traditional providers are likely to be perceived by consumers as “too little, too late.”

Healthcare compensation committees should be aware, however, that accelerating service or utilizing technology alone will not constitute the type of innovation needed to survive and succeed against these newer for-profit retailers, which are experienced in giving the customer what they want while turning a profit. As digital connectedness enables real-time video and audio interactions between medical personnel and patients in disparate locations, traditional benchmarks measuring gradual improvements like “third next available appointment” will fall away. True disruptive innovation only succeeds when it replaces high cost and complexity with simplicity, convenience, accessibility, and affordability—and achieves effective outcomes.

Executive compensation arrangements will need to shift to align with and track an organization’s ability to accelerate *simultaneous* improvements across clinical outcomes, length of service cycle, patient experience, consumer cost, financial efficiency, and operational simplicity.

Typical healthcare variable compensation plans measure organization performance in areas such as care quality, finance, patient ratings, compliance, employee ratings, etc. and executives may earn some portion of their incentive by performing well against some metrics, even while performing poorly against others. Healthcare organizations seeking to truly disrupt their status quo and innovate in care delivery will develop incentive compensation arrangements that define the end-vision the board seeks. These compensation plans will likely be designed so that incentive awards are generated only when the organization demonstrates success across all performance areas simultaneously and thus is able to achieve its stated mission.

Retaining Key Executives

Over the past few years, executive compensation program design in healthcare has focused on how to best ensure a strong focus on “pay for performance.” Boards and senior management teams spend a significant amount of time discussing:

- What are the “best” performance measures to use in the annual incentive or bonus plan?
- Should performance be measured at the corporate level, the division level, the individual level, or all of the above?
- Should we add a long-term incentive plan to the overall executive compensation program to ensure a focus on multi-year business strategies, goals, and results? If so, are we able to set goals accurately over a multi-year time horizon given industry uncertainties?
- How can we set realistic, yet stretch performance targets for each of the measures in the organization’s annual and long-term incentive plans that both senior management and the board are comfortable with?
- What should the payout curve look like; i.e., how much should we pay for performance results above or below target?

What sometimes gets lost in the conversation is that executive compensation programs should not only pay for performance, but they also need to be competitive in order to attract and—importantly—retain the executive team. Boards seeking to implement a balance between pay for performance and retention in their executive compensation program design might consider some of the following:

- Conduct regular market assessments to ensure that total compensation remains competitive with labor market competitors.
- Introduce a long-term incentive plan, which not only focuses executives on multi-year performance but can also serve as a retention vehicle as typically an executive would have to be employed through the end of a multi-year performance period in order to receive an award.
- Implement above-market base salaries—typically targeted at high performing individuals who are critical to the future success of the organization. Supplement performance-based programs with retention programs, which may be designed to provide for a cash payout to key executives if they stay with the organization for a defined retention period. Cash retention programs are sometimes used to further reinforce executive retention during a period of uncertainty for the organization.
- Add a supplemental retirement program to provide income for key senior executives in their retirement years. These programs have built-in retention features, as vesting and payout of the retirement benefits only occur after a defined age and/or years of service have been reached. Nonqualified retirement plans can be customized to each individual to provide a greater benefit/retention focus to select key members of the executive team.

- Adopt executive employment agreements which not only define roles and responsibilities for each executive but also outline compensation program terms and usually introduce severance benefits that would be paid under various termination scenarios (for example, involuntary termination without cause, acquisition of the organization by another organization, etc.). Executive employment agreements with severance provisions are quite common in the healthcare industry and serve as retention vehicles by reducing some of the personal financial risk that may occur in working for an organization in a volatile industry.

In developing or updating executive compensation programs, boards and senior management teams should be mindful that the programs need to meet the organization's pay-for-performance *and* executive retention objectives. Well-designed programs which achieve both of these goals will facilitate the organization's achievement of its mission and business objectives.

Balancing Intrinsic and Extrinsic Motivation

Among compensation committees and senior executive teams, it is often said that "incentives drive behavior" or "incentives drive performance." We believe these statements are fundamentally sound but can be somewhat simplistic as they do not take into consideration the myriad other factors beyond pay which impact individual behaviors and ultimately translate into individual and organization performance. The possibility of other influential motivations is more likely in an industry such as healthcare.

Executives choose to work in healthcare for many reasons, but often there are attractive characteristics of the industry not available elsewhere. One is the social mission—the interest in working for an organization that improves the lives of people in their communities. This may appeal to some of the "intrinsic" (i.e., innate or internal) drivers of executives especially drawn to healthcare who want to have the ability to make decisions in the best interests of the community. Often, because executives' internal needs can be met in the healthcare industry, some organizations may be able to attract and retain high quality talent but at a somewhat lower "price" than would be required in another industry or type of organization, such as a for-profit entity which often has a more singular, financial endeavor. The growing presence of leaders from large retailers, commercial insurers, and other for-profits seeking to disrupt the healthcare industry and help lead its transformation will presumably have an impact on these dynamics.

This balance between intrinsic and extrinsic motivators (compensation is one of the latter) adds significant complexity to executive pay program design in the healthcare industry relative to others. Healthcare organizations need to develop incentive plans that support the achievement of multiple aspects of the organization's performance—financial, patient care and quality, reimbursement rates, and the like—while also aligning the mission, business goals, and culture of the organization with the interests of the executive team. In designing these plans, the following guidelines may be helpful:

- Find the right balance between the simplicity and comprehensiveness of performance measures.
  - Not all aspects of work are measurable—the more aspects of work that are measured, the more complex the resulting plan design, and thus the less likely the plan will be able to motivate participants.
- Seek global or broad measures of performance.
  - Targeted measures that break the work into distinct piecemeal tasks may be perceived as controlling and can negate some of the positive intrinsic value of working within the organization.
- Identify high quality measures that clearly map to the organization’s goals and mission. Calibrate performance measures with moderately-sized financial incentives.
- Avoid overemphasizing financially-focused incentives, which may not align with other aspects of organization performance or individual motivation. A financial penalty on executives for poorer financial performance will have a strong impact as there will be weaker alignment between intrinsic factors and achievement of the organization’s mission with compensation results.
- Identify performance measures which the executive may effectively impact. This can be a highly complicated balancing act between financial, operational, and mission-based performance measurement and the individual factors which motivate executives to work in a mission- and community-based organization. Particularly in the not-for-profit space, open and frank communication between executives and the board around the expectations of each can be very beneficial.

Addressing Gender Pay Issues

In 2018, gender-based pay issues became highly visible across industries and geographies. The UK required employers to disclose median and average pay and bonuses for men and women. New state laws went into effect which included broadening the definition from “equal work” to work that is “substantially” similar. Proxy advisory firms and institutional investors are pushing for disclosure of gender pay statistics, with some high-profile organizations voluntarily making such disclosures. And the broader #metoo environment around sexual harassment and discrimination has served to brighten the spotlight on this issue.

Media attention and public disclosures have frequently been focused on the “gender pay gap,” which has generally been reported as 80%—meaning that on average—women are paid 80% of men. New state legislation (as well as current state and federal legislation) focuses on “gender pay equity” and ensuring that men and women who perform substantially similar work are paid the same, unless factors such as performance, experience, and location can reasonably explain pay variations. Given the sensitivity about these issues, clarity is important so as to not create even more confusion and eventually lack of trust.

It will be important for boards to become engaged on gender pay issues for a few reasons:

- *Managing risk*: There is the possibility of compliance risk if pay levels and practices are not reviewed to ensure gender is not playing a role in any disparities, particularly in states that have recently passed pay equity legislation. There is reputational risk in the event legal action is taken under new or existing state pay equity legislation. Furthermore, while in the near-term hospitals (especially not-for-profit) may not need to disclose gender pay gap statistics, staying on top of this issue may mitigate potential problematic disclosures in the future.
- *Enhancing the talent pool*: The gender pay gap is undoubtedly exacerbated by fewer women in leadership roles. A likely contributor to this is societal norms that may lead to absences from the workforce (e.g., raising children) and greater need for work/life flexibility, which in turn may create greater challenges for women to progress. Organizations that can address these challenges stand to strengthen their talent pool for future leaders.
- *Strengthening organizational culture*: In today's environment of increasing transparency and a workforce that places increasing value on work/life balance and a positive work environment, it will be important for employers to ensure their approach to talent management and compensation is at worst gender neutral and better yet, recognizes longstanding challenges facing women and works to address them. More often, boards are finding themselves involved in trying to ensure a strong, positive culture, which in turn can have a significant impact on organizational success.

The issues related to gender equity can be complex and nuanced. It is important that boards make sure management is active in addressing these issues. First, if the state has existing or recently enacted pay equity laws, ensuring that management has plans to assess pay practices and pay levels within the context of pay equity will be important. Second, understanding the pay gap that may exist is important, as well as developing longer-term plans to address the gap. With a baseline understanding of the pay gap, an annual review to monitor progress can help inform potential policy changes. Finally, consideration should be given to how the organization will manage both internal and external communications around this sensitive, yet important topic.

Expanding the Scope of the Compensation Committee

Since the expansion of the regulatory environment via Sarbanes-Oxley and Dodd-Frank implementations, board of director and committee roles have increased dramatically, not only for publicly traded companies, but for all types of organizations across all industries. The rise of shareholder activism shines light on the fact that investors and stakeholders are increasingly concerned about social issues not traditionally discussed in the board room: diversity; ethics; and corporate, social, and environmental responsibility.

We're seeing the role of the compensation committee moving beyond the traditional realm of compensation based on budget, target pay, and quantitative lenses to include broader strategy, human resources, and corporate social responsibility aspects that can drive additional value for firms. While this trend is most noticeable within publicly traded companies, it is also gaining traction among healthcare organizations who view these approaches as “best governance practices.” They are adding board of director compensation, broad-based pay issues, executive succession planning, leadership and talent development, and corporate culture oversight to their agendas.

Outcomes include organizations updating their compensation philosophy to include statements confirming commitment to fair and equitable compensation to all employees within the organization, expanding ethics and morality clauses in employment agreements, and reviewing and modifying clawback provisions.

Several organizations have gone so far as to expand or change the name of their compensation committee to directly reference the HR, talent, and/or leadership matters that are actively covered by the committee. (According to a recent study of publicly-traded organizations, more than 20% of committees that focus on compensation also reference other areas of oversight within the committee name.) We expect this trend of an expanding scope to continue for the foreseeable future and for organizations that have not yet been thinking about some of these items, we anticipate increased discussion and action regarding the committee’s roles and responsibilities.

Looking Forward

As we have learned in the past decade or so, there are no simple answers to healthcare reform. While the scope of the challenges facing the healthcare industry and its leaders is vast, there are many advancements taking place and new models are becoming the norm. While they are not a magic wand, carefully constructed compensation plans for the executive leaders enacting this change can provide a useful and effective tool for boards.

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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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