The Top Healthcare Compensation Issues for 2016

Transformation in healthcare is an extended journey over uncharted waters, featuring untested business strategies, unprecedented capital risk, and lofty performance requirements for executive teams. Compensation Committees are now tasked with keeping watch over the long haul and may need to quickly change course and extend the timeline for assessing enterprise success. The importance of setting strategic goals and measuring and rewarding executive performance is at a premium, as is the Board’s ability to identify and retain future leaders that understand where the industry and their organization is going.

We believe healthcare Compensation Committees face five key issues in 2016:

1. Addressing risk with long-term incentives;
2. Aligning long-term incentives to transformation-of-care goals;
3. Setting the right balance of performance criteria to drive change;
4. Effectively using pay-for-performance analytics; and
5. Developing leadership teams for the future.

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

“The Board’s role in helping to facilitate enterprise success in healthcare is at an all-time high.”
1. **Address Risk with Long-Term Incentives**

Long-term incentives (LTIs) generally comprise the largest component of executive pay in public companies—organizations whose stakeholders are seeking a return on their investment. The emphasis placed on long-term incentives is based on the need for management to achieve strong, sustained, year-over-year performance, realize the organization’s strategic objectives, and facilitate growth in stock price in order to maximize shareholder value and foster continued investment. In these companies, the Compensation Committee has an expanded period of observation before having to commit to the payment of long-term awards.

In the Affordable Care Act (ACA) era, a healthcare provider’s “shareholders” are the prospective patients residing in the organization’s service areas. “Value” to these patients and their insurers will be defined as access to services that improve population health, provide efficient and effective preventative care, and deliver successful treatment of chronic diseases and serious injuries. Much of what constitutes value in 2016 is quite different than traditional measures such as gains in admissions, inpatient market share, and average cost per discharge.

Boards are expecting their leadership teams to establish these new “accountable care organizations” by initiating strategic alliances with a wide variety of channel partners and reengineering medical service delivery across the continuum of patient care—an undertaking which may require several years or more to achieve.

As Directors and executive teams identify strategic, longer-range transformational goals, it may be difficult for the Board to discern whether the organization is demonstrating short-term results indicative of future success. The Board may need to see more than a single year’s business results before committing additional capital to the continued transformation of the organization and to the payment of executive incentives. Using long-term incentives, in a manner similar to public companies, allows the Board to lessen some of the risk associated with making capital decisions before the organization demonstrates that it is capable of implementing strategic changes successfully and begins to realize the financial gains associated with the transformation of care. long-term incentive goals.

2. **Align Long-term Incentives to Transformation-of-Care Goals**

The industry’s new broad transformational goals are ideally suited for compensation plans with LTIs and multi-year measures that are sensitive to, yet not duplicative of, annual goals. These long-term metrics must balance strategic and financial imperatives with long-term community health outcomes, care quality, and patient satisfaction initiatives.

As hospitals are changing their business models and taking on more financial risk through accountable care models, designing a corresponding performance-driven long-term incentive plan requires they identify the specific criteria on which to evaluate their future
success. Each organization’s mix of future-state indicators will be different, but can include goals such as:

- Shifting inpatient to outpatient care;
- Ambulatory care volume and quality;
- Entering into bundled payment arrangements which assign financial and performance accountability for many types of care delivery;
- Market share via alliances with other providers;
- Negotiating and establishing partnerships with various channel partners (e.g., primary care physicians’ groups, specialty clinics, chronic and home care providers, etc.);
- All-time high levels of performance in the areas of clinical quality, efficiency, and patient satisfaction; and
- Ability to control cost and coverage via risk-managed insurance programs and financial efficiency.

A carefully designed annual incentive plan is critical to focusing the executive team on these clinical, financial, and performance criteria and while the future vision of healthcare providers will obviously differ from each other, Compensation Committees incorporating LTIs into their overall executive compensation program should:

- Identify the unique LTI metrics indicative of the Board’s vision of future success;
- Focus on rewards for the executive and management positions with the ongoing ability to impact corporate performance;
- Establish award opportunity levels that are supported by relevant market practices;
- Consider a design that is straightforward and easy to communicate with few moving parts;
- Provide for a larger reliance on the long-term plan in achieving market competitiveness among the most senior executives; and
- Engage in robust financial cost modeling based on multiple performance scenarios.

3. Set the Right Balance of Performance Criteria to Drive Change

As long-term incentive metrics will likely vary by individual healthcare organization and depend on how far it has traveled on its transformation-of-care journey, the short-term component also plays a role. We know that the short-term metrics should be different than those used in the long-term incentive plan and successful performance on the short-term metrics should complement and predict strong performance against the long-term goals.

Generally, annual incentive metrics tend to center on measures that are financial in nature and that approach will continue to be important to ensure the continued viability of the organization and its ability to execute transformation. A number of other metrics in short-term incentive plans serve to balance executives’ attention across several other factors critical to success, including near-term measures of clinical quality, patient experience, and physician and employee engagement—which have become important in driving broader strategic changes.
Provider organizations seeking to establish measures and metrics for long-term incentive arrangements must look to future indicators of organizational value, much as public companies seek a higher share price for their stock. Hospital and healthcare systems’ ability to transform according to the care goals noted on the previous page will also need to rely on incremental, milestone efforts. Establishing an overall, unified design that rewards strong performance against short-term incentive goals that complement the overall transformation strategy will increase the likelihood of achieving long-term incentive goals.

4. Effectively Use Pay-for-Performance Analytics

With the increased emphasis on the use of annual and long-term incentives comes the greater need to assess the effectiveness of these plans, including the relationship between pay and performance. This is not an easy task, as evidenced by Corporate America’s struggles to align executive compensation and shareholder value.

Key to the assessment of pay and performance is examining the alignment between such things as:

- Incentive measures and metrics with the strategic plan;
- Executives’ line-of-sight and their ability to impact results with plan measures;
- Performance level of the executive team against incentive goals and level of overall organizational performance;
- Level of performance with the amount of incentives paid and overall plan costs; and
- Organizational performance and market compensation competitiveness.

While the basic mission of a healthcare provider is to improve the health of the people they serve, in the ACA environment there is an ever-increasing focus on financial and operational efficiency. The underlying premise is that the growing emphasis on prevention over acute care will bring about improved patient outcomes, stronger reimbursement rates, and reduced costs of care. Testing and monitoring the relationship between changes to operations and care delivery, patient outcome-based measures, and financial performance will be critical.

Pay-for-performance analytics is where the rubber meets the road. This analysis shows the relationship between the level of executive performance against metrics, resulting organizational success, and compensation competitiveness.

At the end of the performance year the Compensation Committee should ask management for an assessment which includes:

- Actual performance against the expected range for each annual and long-term incentive metric (e.g. how far below or above target);
- Final calculated annual and long-term incentive payout levels against the established award opportunity range (e.g. threshold, target, maximum);
- Organizational performance against identified financial and non-financial goals;
Market positioning of total cash and total direct compensation for the executive team in aggregate and by individual executive position; and
Overall cost of the executive program against an identified measure of margin or earnings.

By conducting this pay-for-performance analysis each year, the Compensation Committee can make informed decisions about the performance of the executive team, ongoing incentive plan eligibility, award opportunity levels, and plan design, including measures and metrics, weighting, relationship between the annual and long-term plans, the appropriate levels of discretion in determining plan awards, etc.

5. Identify and Prepare the Next Generation of Leaders

Among the most important responsibilities of the Board is ensuring the organization is led by executives who can provide visionary, strategic, and operational leadership. This has historically involved developing and monitoring a succession plan for the CEO. While this is still of paramount importance, given the dramatically changing healthcare environment it will also be critical to identify the broader organization’s next generation of leaders.

The Board, its CEO, and senior executives will need to identify and prioritize those skills and competencies critical for the organization’s long-term success—which may differ from those highly valued in the past. The ability to demonstrate strong and decisive leadership in a sea of change will be critical, while at the same time the capacity to listen to input and adapt will be equally important. Another important characteristic is the ability to define and take calculated risks, which is somewhat counter-cultural.

While future talent may come from outside the organization, it is oftentimes preferable to identify internal talent. Identifying the right “homegrown” leaders can send a positive message to staff about their own careers. Knowledge of current people, processes, and structure can also be advantageous. However, these new leaders will need to effectively balance their internal credibility with the ability to make difficult strategic decisions.

With the identification of high potential internal candidates comes the need to enhance existing strengths and develop skills and competencies where gaps exist. Management should create opportunities to stretch developing leaders to better gauge readiness, while maximizing their skills. The growing use of long-term incentives in hospitals and healthcare systems may provide an opportunity to expose future leaders to the strategic challenges faced by the organization, and strengthen retention. Extending even modest LTI opportunities to high-potentials can raise their awareness of long-range goals and allow them to participate in management discussions at a higher level, assisting senior leaders in assessing management readiness. LTI eligibility for mid-levels also serves as an important retention touchpoint, acknowledging their contributions to the future of the organization and providing financial incentive to stay on board.
While the identification and development of the next generation of leaders is often the responsibility of the CEO and his/her leadership team, it will be important for Boards to help ensure a proper level of attention to this by selectively allowing expanded eligibility for variable compensation and by monitoring progress.

**Looking Ahead**

As we continue the ACA journey, the Compensation Committee’s role in helping to facilitate enterprise success in healthcare is at an all-time high. Boards in this industry are likely to find the requirement to spend time and care crafting a multi-year, business strategy-based pay program—including successful communication of the plan and monitoring, measuring, and adjusting for effectiveness—is emerging as the new normal.
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About Pearl Meyer

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