Top Healthcare Executive Compensation Issues in 2017

While the names and faces in government change, healthcare system compensation committees are still in the business of developing executive compensation arrangements. Many directors are justifiably concerned that Washington’s potential move away from the Affordable Care Act (ACA) will also constitute a move away from value-based care, and diminish their ability to measure real success. Whether ACA is to be repealed, replaced, or changed, most in the industry agree that some form of value-based care is the only way to control spiraling health care costs, and is still the way forward. Additionally, the move from fee-for-service to fee-for-value in Medicare has been heavily influenced by the Medicare Access and CHIP Reauthorization Act (MACRA), which was strongly supported in both houses of Congress, and appears to be in place long-term.

So, while the outlook in the health insurance marketplace continues to be blurry, the care delivery side of the ACA, and its ongoing movement towards population health, seems to be permanent. Despite this uncertainty in the marketplace, we offer five areas within healthcare executive compensation where boards can push forward effectively in 2017.

1. Incentive Goals and Planning for Flexibility

As boards and management teams are refining their strategies for success, they must also identify how they will measure progress and achievement. The board may determine that executive compensation can serve as a dynamic management tool to help facilitate the organization’s progress towards its long-term mission. The biggest challenge is often setting appropriate goals. The development of a long-term incentive (LTI) plan, for example, will require specific metrics that align with the organization’s long-term strategic plan, define future enterprise value, and are roundly accepted by the board and management.
Identifying these metrics can be extremely challenging, and requires open discussions across the leadership team, and between executives and the compensation committee. Further, LTI plans can incent senior leaders to make decisions in the short-term that are necessary to bring about long-range success, but may come at the expense of immediate concerns. While long-term incentives are somewhat new to the industry, short-term or annual incentive plans continue to play a key role in aligning executives with critical, immediate business goals. A well designed plan optimally signals priorities, balances short- and long-term goals, and aligns the efforts of the executive team with the long-range vision of the board.

Committees electing to establish a pay-for-performance approach to executive compensation incorporating both annual and long-term incentives, are usually best-served by first defining the long-range metrics. Then, with a future vision identified, the committee and management team can develop the short list of key performance indicators that are critical for reaching and/or sustaining a positive position, thereby allowing the organization to move towards its long-range goals. Annual incentive plans should encourage executives to establish and oversee the people and programs necessary to help the organization achieve and surpass its annual financial, clinical, operational, patient, and employee goals. And they should be identified such that year-over-year positive performance against those goals puts the organization in a position to successfully move towards its long-range vision.

The volatility of the industry does make it more difficult for committees and management teams to establish minimally expected, targeted, and stretch levels of performance against annual and long-term incentive plans. The administration of variable compensation programs in this environment is not uncommon in other industries and experience shows the committee is often required to make some decisions about whether or not to approve incentive awards due to unanticipated or unprecedented events. Any inflexibility built in to an existing formal incentive plan which does not allow the board to reward plan participants when required levels of performance are not reached due to unforeseen events or other factors, should likely be revisited due to the possible negative consequences.

However, there are a variety of ways in which the committee can make a discretionary decision about overriding established incentive plan parameters even when discretionary policies don’t exist. These include modifying the underlying goals within the plan, adjusting individual payments to executives, or adjusting the pool of available dollars. Whatever the approach taken, it is a good governance decision by the committee to establish a predetermined policy with some parameters around the use of discretion. The committee should determine the role of the committee versus the full board in this process, as well as the role of the CEO with regard to other executives.
Other discretion policy decisions include: Who decides when discretion should be considered? Will the committee establish a high and low end for adjustments? Can the committee make discretionary decisions about all incentive plans? Are there certain circumstances in which discretion will not be considered, and certain circumstances which dictate whether the committee modifies plan goals, adjusts payments, or adjusts the incentive pool? As a matter of transparency and offering clear communication of the program, compensation committees should consider drafting a document which addresses these questions, and include it as part of the stated executive compensation philosophy.

2. Board Evaluations and Succession Planning

The role of a healthcare organization director, whether non-profit or for-profit, continues to increase in complexity. Boards and their committees are charged with overseeing increasingly complex programs, including the development of executive compensation plans that align pay with performance. With this premium on director contribution, an increasing number of healthcare systems recognize the value of conducting annual board evaluations and reviewing board succession.

Current industry circumstances have made the review of management succession almost mandatory, as many organizations have seen first-hand the chaos that follows unplanned executive departures. Board member departure will not likely have as strong an impact. However, disruption in the board composition can impact an organization’s ability to achieve its longer term strategic goals. Increasingly in the healthcare industry, directors are often selected based on a specific skillset, advanced knowledge in a certain industry, area of expertise (e.g., finance or government relations), or complementary business experience (e.g., healthcare operators). Critical to effectively reviewing board succession is an understanding of what skillsets are required by the board. Developing a matrix which captures the areas of focus for the board as well as the skillsets needed can be a useful tool in board evaluations. Boards can conduct annual reviews to determine whether current board membership has the sufficient skillset mix to address each point in the matrix, whether an additional board member should be considered, or if a current board member’s contribution is no longer critical.

A common approach to cycling board membership is the adoption of mandatory retirement ages or term limits, which in effect force a board’s focus on the succession process. However, an increasingly larger number of influencers recognize that this practice is limiting, as the contributions of a board member cannot be dictated simply by age or tenure and requiring the departure of a valuable director is likely not in the best interest of an organization. Therefore, in lieu of this practice, boards are beginning to expand their annual review process beyond assessments of overall board process and skillsets to evaluating directors through individual assessments of performance and contributions (or less common confidential peer evaluations).
Generally, director performance evaluations are conducted through confidential surveys which are designed by the board, at times with the assistance of outside advisors. Assessments typically include questions requiring a ranked response, allowing for information to be easily tallied and enabling cross-comparison of directors.

Evaluating an individual director’s performance is an essential step in succession planning. The evaluation process should evolve over time as the required skillsets change. Further, conducting these evaluations serves as an important reminder that in today’s governance world, serving as a director is no longer a lifetime appointment, and that the role of a director is often to provide a specific element of guidance to the organization.

As a healthcare organization navigates substantial change and works to create and execute a long-range strategy, boards have an increasingly important role to play in its overall success. Board succession planning, board evaluations, and individual director evaluations become an important governance item to be addressed annually.

3. Compensation Committee Oversight

The span of oversight authority for many healthcare compensation committees may still begin and end with the CEO. That oversight role has been expanding however, and now often includes the full executive team. While there are a number of reasons for this evolution, three are key: 1) the expanded use of variable compensation; 2) the need for compliance with IRS Intermediate Sanctions regulations; and 3) greater market demand for highly qualified healthcare executives from a limited labor pool.

Expanded Use of Variable Compensation

As healthcare boards increasingly use executive compensation as a dynamic management tool for driving organizational transformation, greater efficiency, clinical quality, and an improved patient experience, they are realizing that pay-for-performance programs can often have more impact when the CEO, his/her direct reports, and often an additional layer of managers are “plan-eligible.” In order for the committee to properly assess the effectiveness of variable pay, they often must assess the full management team with regard to relationships between level of performance, size of incentive awards, market positioning of total cash compensation levels, plan cost, and overall organizational performance. With purview over the entire executive team, the committee can better conduct a cost/benefit analysis of the executive compensation program.

Compliance with IRS Intermediate Sanctions Regulations

Independent directors serving on the compensation committees of 501(c)(3) tax-exempt organizations are directly liable for IRS financial penalties if executive compensation and
benefit arrangements are deemed unreasonable, for any “disqualified individual”. For this reason many non-profit healthcare compensation committees have expanded oversight to all "disqualified individuals” or executives, typically C-suite positions.

To the extent that the organization has implemented variable compensation programs, supplemental executive retirement plans (SERPs), or meaningful executive perquisites for any executive position, the committee must review all arrangements to ensure that the total rewards level for each position is not unreasonable when compared to the value of the services received and based on what occurs at similar organizations. The compensation committee then must review base salaries, incentive payments, and the employer cost of all benefit programs for all executives on an annual basis to ensure compliance.

**Greater Market Demand for HighlyQualified Healthcare Executives**

Many mid-market provider organizations must hit and exceed the trifecta of efficiency, clinical quality, and patient experience in order to negotiate successful alliances with adjunct service providers, grow market share, and have more control over their own destiny. Those choosing to take on the challenge need leaders with the requisite experience, whether it be physician executives or those from an expanding list of adjacent industries such as finance, insurance, hospitality, and others. Competing for these individuals with traditional salary and non-qualified retirement plan approach can be challenging, requiring compensation committees to consider programs that are more leveraged by variable pay and more similar to the public companies from which they are recruiting.

Greater demand coupled with a smaller qualified labor pool is driving up the asking price for many candidates. Public and non-profit healthcare organizations working with a finite budget are learning that it is more prudent to compete with variable compensation that must be earned by executing the board’s mission, rather than fixed-cost investments that must be paid regardless of business outcome. Compensation committees must be active participants in the design, oversight, and administration of these incentive arrangements across the leadership team.

**4. Supporting Innovation**

Innovation can have a substantial impact on an enterprise and can pose a threat if external innovation is not monitored. Despite being a ubiquitous concept in many industries—including medical devices or pharmaceuticals—innovation has not traditionally been prioritized within healthcare systems. However, today the industry is providing real opportunities as start-ups, retailers, and technology companies are finding their place within the healthcare market. Further, as healthcare continues to face price pressures through rising labor and pharmaceutical costs and lower reimbursement rates, all while addressing
an aging population, the industry is likely to benefit significantly from innovation in technology, operations, and patient care. Wearable fitness and health monitors, enhanced patient experience through mobile communication, and data-driven care are all examples of industry-changing innovation.

Boards are not generally charged with leading innovation development or deployment, but they can help to drive it into an organization’s culture. Boards can establish innovation as part of their vision and communicate that with management via the organization’s long-term business strategy. Further, boards can support and monitor innovation through an organization’s executive evaluation and succession planning process, as well the design of executive compensation programs.

Executive evaluations can incorporate reviews by direct reports who can provide feedback as to whether they perceive their leaders as supportive of and driving innovation. Managers can also provide input about whether innovative ideas or concepts are given enough support to reach final implementation, and whether the right processes are in place for developing and funding new ideas or work streams.

Compensation incentive programs are extremely valuable tools in supporting an organization’s innovation strategy. Traditional incentives reward participants for achievement of financial goals which provide a reward for an end result. Attempting to incorporate rewards for innovation, which can be the starting point for future financial results, into an existing incentive program primarily comprised of lagging indicators can be a challenge. Organizations should consider incorporating qualitative goals and leading instead of lagging measures into a performance plan as a mechanism to reward employees for developing innovative concepts, regardless as to whether the concept was successful.

As boards expand their focus beyond the oversight role to include focus on innovation, the result could be an expansion of responsibilities for certain board committees. The nominating/governance committee will likely be tasked with identifying potential candidates to lead the innovation process, while the compensation committee can aid in developing compensation and recognition programs which reward innovative concepts. Healthcare organizations, their leaders, and the supporting compensation programs should remain flexible to evolve with the rapidly changing business and social environment that is now largely driven by innovation.

5. Revisiting the Definition of Your Peer Groups

A foundational element in any organization’s compensation philosophy is the identification of “peer” organizations that can provide the basis for defining its competitive pay strategy. In the case of executive leadership, common practice is to identify peer group organizations that are comparable in mission, structure, operations, markets served, complexity, and size.
In short, a healthcare provider will most often identify “like” healthcare providers as its competitive universe for executive talent. While this approach is still necessary, boards and management teams likely need to expand their horizons in defining competitive markets for executive talent.

As the landscape for healthcare is ever-changing, the profiles of the executive talent required to lead these increasingly complex institutions are changing as well. Certainly, the majority of executives will require direct and extensive healthcare experience (e.g., patient services or hospital operations). However, today’s healthcare executive should also have skills such as the ability to evaluate mergers with other healthcare providers, or whether and how to execute strategic alliances or acquisitions of entities within the healthcare world. Expert knowledge and strategies for increasingly complex reimbursement systems will be paramount, as will the integration and management of complex technologies largely driven around healthcare information. These executives—with the skills that are emerging as must-haves for any viable healthcare business strategy—may need to be recruited from adjacent industries.

Across almost all industry sectors, including healthcare, distinctions have become blurred. As a result, executive talent acquisition more frequently crosses industry lines, as will the organization’s peer groups. We expect that healthcare boards and leadership teams will continue to expand their horizons when identifying competitive labor markets, understanding compensation practices, and acquiring executive talent. Clearly boards and their compensation committees need to identify more heterogeneous peer groups compared to those traditionally comprised of healthcare providers. In fact, it may be necessary to assemble multiple peer groups to include those driven by industry focus.

In addition to expanding the horizons of the competitive labor market for executive talent, boards and leadership may also wrestle with the appropriate/desired competitive positioning for executives, particularly when drawing from outside healthcare, which may further complicate recruiting. In short, the competitive positioning should be a function of the criticality of the role to the organization’s mission and strategic plans, as well as the availability of such talent in the marketplace. The result will likely be some variation in competitive positioning across executives and the broader peer group exercise can play a large role in successful efforts to get the right team in place.

While seeking executive talent outside of traditional industry sectors and being more strategic in competitive positioning may not be new, we do expect this pattern to accelerate in the years to come.
Conclusion

Over the last few years, the common theme in the healthcare arena is “change” and lots of it. As 2017 continues to unfold, this theme will continue. Healthcare boards and executive leadership will be challenged to develop and execute on strategies that are aligned with the likely long-term transformation to a value-based care healthcare system. At the same time, given the uncertain future of ACA, boards will need to be flexible in the definition and assessment of annual and long-term goals, possibly applying discretion in determining incentive awards, and acquiring and keeping the executive talent required to lead the institution during a time of unprecedented change in healthcare.
About the Authors

Steve Sullivan, a principal with Pearl Meyer’s Houston office, has more than 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 and for tax-exempt businesses. 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. He has experience in the financial services, manufacturing, and information technology industries.

Jim Hudner is a managing director in the Boston office of Pearl Meyer. He consults in the areas of total compensation strategy, executive compensation, compensation planning, base salary management, incentive plan design, and performance management. Mr. Hudner brings 30 years of consulting experience to his position and has consulted to organizations in a wide range of industries including technology, higher education, research organizations, financial services, and manufacturing.

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