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TRENDS
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The Triple Aim and Healthcare Executive Compensation: Top Five Trends for 2020

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Does any industry have a steeper, more challenging goal than healthcare's "triple aim"? Healthcare provider organizations are expected to drive simultaneous, demonstrable improvement across the patient's experience of care and the quality level of their care among specific populations, while addressing their per capita cost. Insurers and channel partners are also naturally pulled into this transformation.

The industry has already taken large and successful steps toward these lofty goals and for many boards, the adoption of short- and long-term incentives in their executive compensation plans has clearly communicated priorities and rewarded management for execution. But as with any industry there are cycles, and healthcare is poised to enter a second wave of learnings on this transformation journey. We outline five emerging trends related to the compensation committee that warrant examination:

- **Discretion:** Changing market conditions may necessitate the use of discretion in long-term incentive award payouts.
- **Mission-Based Metrics:** Many boards are taking a moment to ensure they haven't lost sight of their organization's unique core mission. For some this means exploring mission-based performance measurements in executive compensation plans.
- **ESG:** As every other industry urgently explores its role in environmental, social, and governance issues, healthcare is no exception.

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- **Disclosure in 990s:** Boards are beginning to assume that stakeholder interest in their Form 990s is a given. Is it time to use this filing to communicate a proper level of transparency and rationale for executive pay programs?
- **Leadership Assessment:** The board's role is expanding beyond the traditional nom/gov, audit, and compensation committee structure, albeit more slowly in healthcare than other industries. Currently, healthcare boards are beginning to have more frank discussions with the CEO about succession and talent development.

1. Discretion

The first overwhelming challenge for health system boards was understating how to enact a wholesale industry transformation and move from the traditional inpatient, fee-for-service model to one that is more focused on patient outcomes/satisfaction and population-wide health. Boards have found that assembling the right leadership teams is imperative and have discovered that public company executive compensation practices, such as annual and long-term incentive plans, can help in recruiting and retaining these teams, as well as in driving organizational performance.

However, the era of the triple aim may be entering a new phase. As care successfully evolves out of the inpatient setting, now the challenge of cost transformation is in focus. The ability to forecast revenue and expenses has been impacted by reduced patient volume and associated revenue, an increase in Medicare and Medicaid reimbursements that are unpredictable, and insured patients who have difficulty covering increasingly high co-pays and deductibles. The result is healthcare system leadership teams that have done everything right to help enact the transformation and meet their long-term performance goals operationally may discover they are still falling far short of the financial goals.

In this situation, many corporate boards would readily see a need to use discretion in the payout of their long-term incentives. After all, emerging market conditions have been unforeseeable and largely out of the control of management. But often healthcare directors are fairly new to the use of variable pay programs and this unfamiliarity breeds a reluctance to make exceptions. Which pay-performance outcomes are to be expected and which are not? Which situations require a discretionary judgement about pay which is outside the structured performance and pay program? How can boards avoid "penalizing" teams that have been successful with the programs under their control?

Fortunately, many healthcare executives whose boards have been leaning on leveraged compensation arrangements for a longer period of time have learned that incentive plan goal-setting and performance debriefing is a "team sport" which both requires and fosters mutual understanding and input between the board and management. It's a solution that over time makes clear when, why, and how to use exceptions appropriately and sets the stage for better overall goal-setting and evaluation.

In a best practice scenario, the leadership team can prepare first-draft goals for each of the metrics within their annual and long-term incentive plans and then meet with the board compensation committee to discuss the business reasons and likelihood for each prediction. Committee members should request a presentation of background factors attendant to each area of measured institutional performance, with robust Q&A. At the end of the performance period, executives should similarly prepare a debrief for directors regarding business results and interpretation and engage with them in a discussion of outcomes. These two “before and after” activities should be supplemented by periodic updates by management throughout the performance period regarding the trajectory of anticipated performance against metrics.

The repeated year-to-year exposure to this plan-examine-understand-plan feedback loop can help the compensation committee develop a more formalized approach to the use of discretion in effectively administering executive compensation and overall serves to improve planning and communication between the board and management.

2. The Mission and a Larger Focus on Non-Financial Metrics

As the industry evolves and becomes open to more scrutiny by external media and stakeholders, we’ve been involved in frequent discussions with boards and compensation committees regarding what metrics are most relevant and appropriate for inclusion in both annual and long-term incentive plans. Historically, incentive plan designs for executives of healthcare organizations have been relatively simple and generally focused on financial-based metrics to ensure that the business has the financial means to execute its mission and strategy.

However, stakeholders are increasingly concerned about company mission and that it is not lost in the transformation. Compensation committees have been working hard to determine how to re-focus executives in the areas core to their organization and modifying their executive incentive plans to include non-financial metrics that are key to that mission.

It has become clear that there is a preference for incentive plans to become generally more robust in order to focus and incentivize executive teams on all aspects of the organization, including its mission, financial performance, and operational excellence. Compensation committees are more frequently encouraging their senior management teams to give real thought to what types of non-financial and mission-based metrics can be measured accurately, have clear line-of-sight for incentive plan participants, and can ultimately be appropriately included in annual or long-term incentive plans.

As it turns out, some of the most common mission-based areas that are frequently being discussed for inclusion in incentive plans have clear ties to the triple aim:

- Customer or patient satisfaction;
- Community health and wellness;
- Quality of care (NCQA, HEDIS, etc.) and
- Cost/affordability of care.

Companies are beginning to incorporate these types of metrics into their plans once they’re comfortable that they can accurately measure performance and progress either using external benchmarks or internal planning. Commonly, the metrics are first introduced into an incentive plan at a relatively low weighting (5% to 15%) and become a larger focus of the plan in the following years, once executives and the board are comfortable that the metrics are being accurately measured and reflect actual performance and progress in each of the measured areas.

Thought must also be given to whether the additional metrics will be included in the annual or long-term plan. In making these decisions, there are several factors that should be considered. How acute is the area of focus and does the metric need to be addressed immediately or over the longer-term? How quickly can the management team impact meaningful change and really push the needle? How easy or difficult is it for management to set realistic performance levels over the short- or long-term? While practices vary based on organizational-specific situations, we most often see satisfaction and quality metrics included in annual plans, while community health and cost of care metrics are included in long-term plans.

As external pressures continue to rise and the healthcare industry becomes more complex, we expect incentive plan design and incentive plan metric selection to remain a major focus of discussion among senior management and compensation committees. We expect incentive plan designs to evolve with the changing times and to include all aspects of a company's strategy, with a stronger focus on the organization's mission beyond that of the industry as a whole.

3. ESG Metrics

Over the past year, there has also been a swift and significant uptick in the number of boardroom conversations around the globe about the roles that companies have engaging in and measuring activities and achievements beyond those which are financial and operational. The parlance around these discussions usually focuses on "ESG" or aspects of performance that fall into one of three broad categories: environmental, social, and/or governance. This trend has been driven by socially conscious investors who seek companies that emphasize strong financial performance while also improving the societies in which they reside, do so in a safe and environmentally sound manner, and practice strong governance.

While there are hundreds of finely defined categories, typically environmental criteria will consider how a company performs as a steward of nature, but as an extension will also focus on safety performance within the company in completing its operations. Social criteria examine how the company manages relationships with the communities in which it operates as well as its employees, suppliers, and customers. Governance criteria address the company's leadership, executive pay, audit function, internal controls, and shareholder rights. While there are many aspects to ESG, the bottom line is that strong ESG performance is really about long-term company sustainability.

While ESG conversations were initially philosophical in nature, they have evolved into conversations around the use of ESG measures in executive incentive compensation plans. According to Pearl Meyer's recently published survey "On Point: Looking Ahead to Executive Pay Practices in 2020," 14% of public company respondents currently use or plan to include ESG metrics within their senior executive incentive plans. For those companies that use ESG measures, performance is most commonly measured quantitatively rather than qualitatively. About two thirds of companies have environmental-related measures, one third have social-related measures, and a quarter have governance-related measures. Each ESG measure is typically weighted as 5% to 10% of the total opportunity. For those companies considering adding an ESG measure, all were considering adding a measure in the environmental category.

These statistics are consistent with our experience that ESG measures are currently an emerging but minority incentive design practice. Like many pay program trends, this began among large publicly traded companies and will likely take root there first, but these discussions are now beginning to expand, including into the boardrooms of healthcare providers and insurers.

Beyond the previously mentioned mission-based performance metrics, over the years healthcare providers have frequently used safety-related measures (e.g., patient safety), which do fall in the environmental category. Highlighting these measures as “ESG” may be where we see the trend begin in this industry. Although we have seen little use of measures which are either social or governance in nature, social measures in particular, may be quite relevant—and perhaps identical—to the mission-based metrics of a not-for-profit healthcare company. Finally, governance metrics may be a natural extension and focus initially on diversity of the executive team, employees, and suppliers, reflecting the communities served.

While still nascent, we do believe that the use of ESG measures to assess company performance will only increase over time. As healthcare industry compensation committees begin to consider ESG, showing progress may initially be a matter of thinking about how current performance measures are defined and categorized in an ESG context, and then communicating that clearly.

4. Increasing Transparency: Improving Disclosures

As the ESG trend shows, there are ever-increasing demands for transparency on a wide range of issues, including executive compensation. While the required Compensation Discussion & Analysis (CD&A) disclosures among publicly traded companies usually receive the greatest attention, non-profits do face similar requirements. And given the louder calls for transparency, boards are expecting greater external interest in their executive compensation programs.

Among non-profit employers, the primary vehicle used to provide information about executive compensation is the Form 990 filing with the Internal Revenue Service, which is also available to an organization’s array of stakeholders, including regulators, media, employees, donors, and the public at large. Typically, the primary stakeholder interest is the amount of compensation paid. However, it is also important for an organization to clearly define the rationale used for establishing levels of compensation.

Unlike the CD&A included in a proxy statement, which is structured to provide a clear opportunity for a publicly traded company to explain its approach to compensation, the opportunity for non-profits to provide clarity is not as easy. In fact, given that the Form 990 is a tax filing, there are some reporting quirks that can lead to confusion, such as needing to report annual employer-provided deferred or retirement contributions and then reporting the totality of these contributions when they vest, which can distort the actual compensation earned in the year of vesting. As a result, ensuring clarity of the message is even more important and particularly for those audiences that look at a mix of public and private organization narratives.

Schedule J within the Form 990 has a Supplemental Information section, where organizations can provide additional descriptions or explanation of the questions in Part I or the information for Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees included in Part II of Schedule J. Schedule O is also intended to allow organizations to provide clarifying information on many subjects, including executive compensation. Either of these sections can be used to provide a more in-depth view of the board's approach to interpreting the compensation philosophy, peer organization benchmarking, and performance expectations. Further information can include the current competitive labor market or how compensation aligns to the organization's mission and key strategic objectives. Of course, information on the compensation philosophy can be posted on the organization's website, possibly with the latest Form 990, its associated schedules, and the annual report or financial report, further demonstrating a commitment to transparency.

This is minority practice today but one that we believe to be a best practice in terms of enhanced transparency and enabling the company to get ahead of the media by proactively communicating its executive compensation approaches. While some organizations may be concerned that focusing on the issue will only serve to heighten scrutiny, we believe it helps the organization properly frame the discussion by providing a clear rationale for its compensation practices and the benefit programs in place. The time and effort spent in advance is preferable to the time and effort spent reacting to bad press due to misunderstandings and/or bad assumptions about the program design.

5. Leadership Assessment

Given the complexity and long-term nature of the triple aim and the short supply of high quality leaders, it's a given that few healthcare organizations will retain their leadership teams throughout the industry's transformation. Healthcare provider boards must then secure a long-range steady supply of qualified leaders who understand the importance of the pursuit and how healthcare services need to evolve. While healthcare is somewhat late to strategic succession planning when compared to other industries (similar to its lag in strategic executive compensation structures), provider boards are beginning to have more frank discussions with their CEOs about the qualifications and performance capabilities of the entire leadership team.

As the compensation committees for these boards assume more responsibility for guiding the organization's leadership development process, they must focus on recruiting, motivating, and retaining high performers across the entire c-suite, not just for the CEO position. Additionally, the long-term proposition of building a culture focused on population health will require the identification, evaluation, and development of talent in the ranks below senior management.

Although many senior healthcare executives now participate in some type of long-term compensation structure which may provide some deterrent to leaving the organization, the risk of departure may be greater among their direct reports actively seeking advancement opportunities. It may not be appropriate for boards and committees to oversee the direct management of those below the c-suite, but directors can and should engage the executive team in broad conversations about the career development and compensation opportunities in place. Boards may be able to secure a stronger and longer-range c-suite pipeline by ensuring that management is maintaining talent development as a strategic priority. Management development of earlier careerists is fairly new to healthcare, and the board's ongoing focus in this area can encourage the CEO and the leadership team to build and maintain effective programs.

At the same time, it is critically important for compensation committees to understand the broad remuneration programs in place across their organization, direct and indirect, broad-based and executive. The committee and management together are responsible for developing and articulating an executive and workforce compensation philosophy and market positioning strategy for all of the elements of total rewards. To the extent that the identification and retention of management talent is a key consideration of the compensation philosophy, the workforce compensation program will include individual performance as a key criterion, likely influencing individual pay levels and eligibility for variable pay arrangements. These incentive programs—when they communicate acknowledgement and opportunity—can be critical to the organization's ability to provide compensation that is more than just a livelihood.

Because compensation alone is seldom an effective retention program, compensation committees will also need to partner with CEOs and other leaders to establish other meaningful touchpoint opportunities for future leaders. Committees should work with their executive teams to identify the knowledge and skill areas it will need to continue evolving population health, and to assess the readiness and skill match of existing and potential leaders. The findings may inform a variety of management development programs such as education, assignment rotations, and individual mentoring. Future leaders, provided with real development opportunities and expanded pay opportunities may decide that their current situation, with a total rewards approach, is better than what they may find elsewhere. The board's expanded partnership with management to employ very specific enterprise-wide employee assessment, development, and compensation programs allows the organization to strengthen and lengthen its c-suite pipeline with those individuals able to successfully drive meaningful improvements.

Conclusion

These five issues—discretion in payouts, mission-based and ESG-focused metrics, pay transparency, and leadership development—are a reflection of executive pay practice trends across industries. Their uptick in the healthcare space is evidence of this industry's maturation relative to mainstream corporate practices, as well as its movement along the triple aim continuum. Boards which focus their compensation committee around appropriate use of judgment, nontraditional performance measures, the pros and cons of enhanced disclosure, and thinking beyond compensation to broader talent issues will position their organizations for future success in a rapidly evolving industry.

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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, Raleigh, and San Jose.

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