The American Hospital Association's Great Boards
Promoting Excellence in Health Care Governance

Balancing Act: The Compensation Committee's Role in the Peer Group Selection Process

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This article examines the selection and use of executive compensation peer groups for tax-exempt health care organizations. These best practices, coupled with sound business judgment and a disciplined governance process, will help your organization achieve a balanced executive compensation program.

The Balancing Act

The board's compensation committee must effectively and responsibly govern the executive compensation program, which involves a delicate balancing act of potentially competing interests. On one side, compensation levels must be sufficient to recruit, motivate and retain an effective leadership team. On the other side, compensation levels are subject to affordability, public scrutiny and regulatory compliance considerations.

Peer group benchmarking is often the foundation for this balancing act. Used properly, benchmarking is an effective, fact-based method that can serve multiple purposes:

- Assessing the market competitiveness of each element of compensation, as well as the total.
- Determining the appropriate mix of fixed compensation, performance-based incentives and benefits.
- Evaluating pay practices, including incentive performance measures, benefit program design, perquisites, severance, employment contract terms and other practices.
- Ensuring the organization's actual compensation is aligned with the market positioning in its pay philosophy.

In addition, an appropriate peer group supports the organization's compliance obligations, which are critical in today's heightened scrutiny of executive compensation. The peer group is the basis for developing "appropriate comparability data" to support establishing the rebuttable presumption of reasonableness under federal tax law, which provides protection to the organization and board members in the event executive compensation is subject to an IRS audit.

The *effectiveness* of this tool, however, is highly dependent on how *responsibly* the committee governs the process used in peer group selection, as well as the use of peer group data.

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Peer Group Selection

Using a Custom Peer Group versus General Published Survey Data

The initial decision in the peer group selection process is whether the organization's executive compensation decisions warrant the development of a custom peer group, versus using available published survey data. For many organizations, published survey data reasonably reflect the market for talent and corresponding compensation levels. In that case, the predefined criteria included in surveys (such as revenue size, geography, and academic versus non-academic status) are sufficient indicators to compile appropriate data.

For other organizations, however, the complexity of operations or geographic location may be such that general published survey data do not adequately capture the true market for executive leadership talent or scope of operations. This may occur, for example, where organizations have unique academic missions or have a mix of both managed care and provider operations. Or, perhaps the organization is located in an area where the market for talent is particularly competitive or the cost of living is high. In these cases, published survey data alone may not be sufficient for compensation decisions. Instead, it may be appropriate to develop a custom peer group of organizations to use for benchmarking. Custom peer group data can be compiled either from surveys, as special subsets compiled from a survey provider or from IRS Form 990 compensation disclosures.

Custom Peer Group Selection

When circumstances call for a custom peer group, a sound process for the selection and use of data is a critical governance component. To be useful and defensible, the peer group should contain peers that are similar to your organization in several defining characteristics and should be representative of those with which your organization competes for talent. The committee should discuss and achieve consensus on the organization's competitive market. Views of senior management and outside advisors are valuable to this process, particularly since board members may be less familiar with the increasingly diverse set of organizations from which executive talent is drawn.

When developing a custom peer group, focus on the characteristics you and your industry competitors have in common. Examples of primary selection criteria often include:

- Structure and complexity of operations – Examples include freestanding hospital, multi-hospital system, integrated delivery system, or academic medical center. In addition, consideration could be given to lines of business among peers (e.g., those that have a managed care plan versus those that do not, those with significant physician groups and those with long-term care operations).
- Specialty focus – Consider the degree to which specialty (e.g., academic medical center, children's hospital, cancer center) may play a role in your recruitment/retention market and in the market data.
- Size – This is an important criterion, since compensation levels are positively correlated to size. For hospitals and health systems, net operating revenue is the most common indicator of size. A general rule of thumb is to include organizations that are about one-half to two times the size of your organization.
- Location – Depending on the number of available peers and the talent market, location may be defined as the surrounding geographic area or region, or it may be organizations in the same "type" of geography (e.g., urban, suburban, rural or major metropolitan area). Many organizations have a national recruitment market, in which case a broader group may be appropriate.
- Tax status – Although the IRS's intermediate sanctions regulations expressly permit the inclusion of for-profit companies in the peer groups of not-for-profit organizations, the data must still be appropriate. If for-profit peers are being considered, your organization must determine whether these organizations, which have different capital structures and a governing objective of maximizing shareholder value, are appropriate to include in the peer group for a not-for-profit organization. If they are included, the data should be interpreted cautiously since compensation may include significant stock and other equity-based forms of compensation that are not available to executives of not-for-profit organizations.

Other criteria may be applied as a validation tool for demonstrating the level of comparability. Examples of secondary selection criteria include:

- National rankings – Consideration may be given to various published rankings or other designations (such as U.S. News & World Report, Truven Top 100 and Magnet Status, among others). Be sure to review the limitations associated with any rankings, as well as the methodology used to identify top-performing organizations.
- Grant funding – Levels of NIH grants and state funding may be important to determine comparability for organizations with significant research activities.
- Bond rating – The comparability of bond ratings provides perspective on whether peers have similar financial stability characteristics.

As you apply these criteria, consider how your decisions will appear to those who might scrutinize your actions. Evaluate your peer group the way the media or regulators would, and be prepared to defend your organization's position. This foresight will be helpful in the event of media, regulator or other stakeholder inquiries.

In recent years, compensation committees have become increasingly interested in strengthening the "pay-for-performance" components of executive compensation programs. Performance data, which is increasingly available through public sources (e.g., Hospital Compare), can be applied to the custom peer group to help determine appropriate performance targets for incentive plan goals. In addition, peer performance data can be used to assess if an organization's performance compared to peers is directionally aligned with competitive pay positioning (e.g., providing 75th percentile pay for 75th percentile performance).

Size of the Peer Group

This process should result in a peer group that is sufficiently robust and reliable. The peer group ideally would contain at least 15 organizations, unless your organization has unique attributes that would support the use of a smaller group. Peer groups of fewer than 15 may produce less reliable data and be more easily impacted by year-over-year changes in the group. Ideally, the median revenue of the peer group would approximate your organization's size to ensure a good fit for compensation benchmarking.

Other Considerations

Be careful that the criteria are balanced and not too heavily focused on just one factor. For example, an organization with a particularly high concentration of regional competitors may be inclined to include primarily those organizations in its peer group, fearing the need to "stay ahead" of the competition in terms of compensation. However, if the competitors are considerably larger and/or more complex, or if there are too few organizations to constitute a robust sample size, the defensibility of the resulting peer group may be relatively weak.

In addition, be wary of focusing on "aspirational" peers for which comparability is difficult to demonstrate. Although a peer group of organizations that are significantly larger, more complex, and/or better performing may be desirable and appropriate for purposes of monitoring organizational performance, including such organizations in the compensation peer group often results in an escalation of pay levels and may lead to claims of "cherry picking." If an organization truly is in an aggressive growth or turnaround stage where an aspirational peer group is appropriate, it should be balanced with peers that are more reflective of the current state of operations to ensure that decisions are made with an understanding of both the current and future competitive landscape.

Consider collecting data from multiple published survey sources, in addition to the custom peer group, as a validation tool. This will ensure a fact base that adequately captures the market. In addition, where a custom group is used, such validation allows the organization to gauge the general marketplace practices so the implications of using a customized group are understood.

Finally, ensure that potential peers have been appropriately vetted and that the committee is engaged in the selection process. If the committee has not been directly involved in the peer group selection process, consider adding a discussion of the peer group to an upcoming meeting agenda. Request a report from management or your outside advisor regarding the current peer group selection process, and develop a plan to ensure a disciplined process and sufficient committee involvement.

Peer Group Documentation

Whether using published survey data or a custom peer group, the committee should document its review and approval process, including the selection criteria used, other supporting rationale and third-party opinions, in minutes of the meetings at which decisions occur. The definition of the competitive market and selection criteria should also be documented in the organization's executive compensation philosophy. In addition to providing institutional knowledge of peer group selection, this documentation supports the organization's compliance with regulatory requirements.

The importance of committee review and approval has been underscored by a 2013 IRS report on executive compensation in private colleges and universities. The IRS found that one in five of the institutions examined as part of a compliance project utilized peer groups containing institutions so different in size or other criteria that regulators deemed them "not comparable." This report reinforces the importance of peer group selection and documentation to ensure compensation decision-making is appropriate.

Peer Group Maintenance

The peer group should be periodically reevaluated to ensure its continued appropriateness. Such a review should occur when either your organization or peers in the group undergo a material change in the scope of operations or size. In the absence of a significant change, peers should be revisited at least every three years to ensure that they continue to reflect the character of your organization and remain appropriate for compensation decision-making.

Conclusion

The compensation committee's role in governing executive compensation is only as strong as the processes it follows. The organization is best served when the committee follows a balanced approach to executive compensation that considers both good business judgment and industry best practices. An effective peer group benchmarking process is a critical part of the committee's oversight of executive compensation. By utilizing a strong process, the board and committee can be confident that the basis for executive compensation decisions is appropriate and, when combined with good business judgment, results in a compensation program that is balanced and defensible.

Peer Group Decision Tree: How well does your organization's approach to selecting peer groups align with best practices? Compare your process to the Peer Group Decision Tree on page 5.

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Peer Group Decision Tree