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The Growing Influence of For-Profit Pay Practices on Nonprofit Executive Pay

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Hospital and health system executives have always dealt with change. But today's executives are responsible for leading their organizations through unprecedented *transformational* change that will fundamentally alter the way healthcare is delivered. Changes in payment models, from volume based to value based, are leading to new patient care delivery models in order to accomplish the new healthcare *Triple Aim*: deliver a better patient experience, improve the health of a defined population and reduce care costs.

Nonprofit hospital and health system providers must also contend with the increased emergence of for-profit health systems that have greater access to capital for meeting these challenges. To compete, both for-profit and not-for-profit hospitals and health systems have been consolidating (including the creation of "mega systems") or entering into strategic affiliations or other arrangements to grow market share, expand service lines or revenue streams and realize efficiencies. The result: health systems that now resemble the size and complexity of Fortune 500 companies.

Governing boards of nonprofit hospitals and health systems are reexamining their executive compensation programs to ensure they can attract, reward and retain the right executive talent required to lead the new healthcare enterprise. These programs must reflect the new competitive environment, support the evolving business strategies and include the appropriate mix of pay focused on outcomes, while still adhering to the charitable mission and the requirement to pay no more than reasonable compensation. This is no easy task. For ideas, governing boards and compensation committees have begun to look at the pay practices of for-profit companies, including the following:

- Evolving use of for-profit companies as peer organizations.
- Increasing adoption of executive long-term incentive plans.
- Measuring the alignment of pay levels against performance.

Evolving use of for-profit companies as peer organizations

This new healthcare landscape requires leaders to be more skilled, experienced and adept at dealing with change. Attracting, rewarding and retaining executives with the skills necessary to lead an organization through this period of change is a critical task for today's governing boards. According to a report from the American College of Healthcare Executives, hospital CEO turnover is at an all-time high: It rose from 17 percent in 2012 to 20 percent in 2013, the highest rate recorded since 1981. The competition for proven executive talent is fierce and is now coming from both within and outside of healthcare, including the for-profit sector. New executive roles are emerging (e.g., physician integration, population health, medical informatics), and existing roles now require executives to have new skills for building and managing under shared risk arrangements, providing quality outcomes in a safe environment for reduced costs and improving population health.

To address the changing and evolving executive talent market and the increased sourcing of talent from the for-profit market, governing boards are beginning to include a mix of nonprofit and for-profit organizations, as appropriate, in their peer organizations for cash compensation benchmarking. Given the diversity of the roles and the rapidly changing industry, it is important to ensure that peer group data match the executive's specific role and the organization's situation. Governing boards and compensation committees should ensure compliance with applicable regulatory guidance (e.g., intermediate sanctions regulations) regarding appropriate comparators.

With the inclusion of for-profit companies in the peer groups, it is unlikely that nonprofits will be able to match the total compensation packages of those given to for-profit executives because of their inability to offer stock or equity-based compensation, which is a major component of for-profit executive pay. However, for certain roles and under certain situations, the gap in cash compensation paid by for-profits compared to not-for-profits may decrease.

Increasing adoption of executive long-term incentive plans

Nonprofit executive compensation packages have traditionally focused on providing annual incentives structured around a balanced scorecard approach. Common measures include financial, quality, patient safety, patient satisfaction, employee engagement and community metrics. In recent years, these have been refined to focus more on outcomes than on process and have expanded to include population health measures.

LTI Plan Prevalence –Large Not-for-Profit Health Systems (Revenue Greater Than $3 Billion)			
2011	2012	2013	2014
36%	39%	41%	46%

Source: Sullivan, Cotter and Associates, Inc. 2011-2014 *Manager and Executive Compensation in Hospitals and Health Systems Survey*

Governing boards recognize that the transformation in healthcare will occur not overnight but over time. To provide competitive compensation with broader labor market peers and to increase focus on long-term outcomes that are aligned with new strategic priorities, more not-for-profit organizations are considering and implementing long-term incentive plans for executives, a common for-profit executive compensation component.

For example, according to data from SullivanCotter's 2011 annual "*Manager and Executive Compensation in Hospitals and Health Systems Survey*," just 36 percent of large health systems provided a LTI plan. By 2014, this percentage grew to 46 percent, and is likely to continue to increase.

While nonprofit health systems cannot offer the stock or equity-based arrangements that for-profit companies can offer, adding an executive LTI plan to the compensation package places a greater emphasis on outcomes aligning closely with the organization's long-term business strategy. LTI plan measures are typically multiyear, enterprise-wide strategic measures linked to increases in market share or fundamentally improved performance. In addition, LTI plans for nonprofit healthcare executives may ultimately evolve to include measures of value creation. Approaches to measuring long-term value creation among nonprofits could include discounted cash flow analysis, change in net assets or comparisons to the market values of similar public companies.

Measuring the alignment of pay levels against performance

Driven largely by shareholder activism and regulatory compliance, for-profit health systems have long ensured that pay is aligned with performance via financial and operating metrics, relative performance metrics and total shareholder return. Given that the financial incentives under healthcare reform require a certain level of performance to avoid penalties and earn reimbursement, along with the continued scrutiny of healthcare executive compensation packages, nonprofit governing boards and compensation committees have grown increasingly interested in measuring the alignment of pay, performance ratings and performance improvement based on benchmark data covering financial, quality, patient safety, patient satisfaction and system integration and alignment measures. Measuring the alignment of pay and performance provides valuable information as to whether pay levels are commensurate with the performance necessary to drive success. If so, this is a great message to share with stakeholders. If not, it is an opportunity to recalibrate and reassess.

While governing boards and compensation committees still must ensure that executive pay is 'reasonable,' which requires adherence to a compliant governance framework and process, they are increasingly looking to the pay and practices of for-profit companies (both within and outside of healthcare) for ideas.

Highly skilled executives capable of effectively leading today's health systems are hard to find, challenging to retain and even tougher to replace. Nonprofit health systems must be able to offer a competitive executive compensation package that can attract, retain and reward these leaders. While governing boards and compensation committees still must ensure that executive pay is "reasonable," which requires adherence to a compliant governance framework and process, they are increasingly looking to the pay and practices of for-profit companies (both within and outside of healthcare) for ideas. This trend is just beginning, but given the rapid change occurring in healthcare and the fierce competition for proven executive talent, it is not likely to end anytime soon. ■