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Transforming Executive Incentive Compensation

by Jose A. Pagoaga

Editor's Note: In his article "Agenda for the Executive Compensation Committee, A Guide for Managing Regulatory and Reputational Risk," which appeared in the winter 2013 issue of Great Boards, Timothy J. Cotter, Managing Director of Sullivan, Cotter and Associates, discussed 10 issues that these committees should be addressing in the current health care environment. This article takes a closer look at incentive compensation. It discusses why health care governing boards should review and evaluate incentive compensation plans for executives to ensure they are rewarding performance consistent with industry requirements and achievement of their organizations' short- and long-term goals.

Unprecedented recent change in the health care industry has caused many provider organizations to devote considerable time and energy to their business strategies. Whether that strategy involves merging with or acquiring another organization, integrating services, developing an accountable care organization or expanding service line offerings, health care leaders understand the need to position their organizations for success in the future.

Incentive plans are intended to focus executive attention on an organization's most important priorities and initiatives; however, the incentive plans in place at many organizations look almost the same as they did a decade ago. As business strategies are reshaped, health care organizations should also re-examine the structure and metrics of their executive incentive compensation plans to ensure that they are aligned with the changing goals of the organization.

While most organizations have already modified their annual incentive plans to incorporate new metrics for quality and patient satisfaction, updating the annual incentive plan may not be enough. More than ever, organizations are implementing long-term incentive plans to emphasize the multiyear transformational goals necessary to fulfill a changing business strategy.

As board compensation committees take a fresh look at incentives, there are questions to consider:

1. Are our incentives designed to drive both the annual and long-term objectives of the organization?
2. If so, do we have the right balance between the annual and long-term reward opportunities?
3. Are we adapting our incentive plans to our changing needs and the evolution of the health care industry?

Reshaping Short-Term Incentives

The following are a few examples of how some health care organizations are adapting their annual incentive plans to current market conditions.

Placing greater emphasis on quality. Historically, quality results – patient safety, clinical outcomes and patient satisfaction – have been tied to a health care organization's mission; now they are tied to its margin as well. The reasons are twofold: first, reimbursement is being increasingly linked to quality outcomes (e.g., the Centers for Medicare & Medicaid Services' Hospital Value-Based Purchasing Program) and, second, with the emergence of consumer-directed health care, consumers have greater access to publicly available quality data and the opportunity to make informed choices about health care providers and services. Quality, therefore, is also affecting volume.

Placing more weight on quality metrics requires shifting weight on other metrics, including financial performance measures. There has been a longstanding belief in the health care industry that a shift away from financial metrics may diminish financial outcomes. However, new research by SullivanCotter indicates that health care organizations with the strongest operating margins also have some of the strongest quality results. Now, and even more so in the future, successful performance on quality measures will help drive financial success – through higher reimbursement and greater consumer choice.

Aligning to total cost of care. As providers take on more of the financial risk of providing

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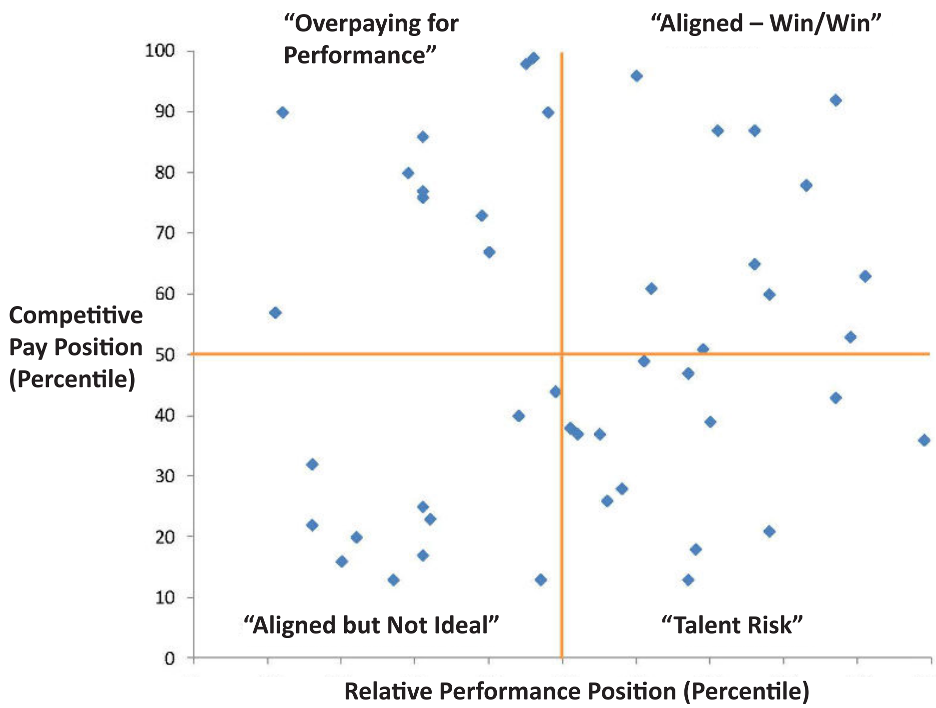
care, there is more pressure to manage the total cost of care. With the industry moving toward population health management, health care organizations will remain financially viable only when they are able to efficiently coordinate care across all components of the delivery system – inpatient and outpatient care, physicians and post-acute providers. To help achieve this, all care providers throughout the delivery system should have their incentives aligned and working together to maximize care quality and efficiency.

Pay and performance alignment relative to peers. Organizations desire to align compensation with performance. However, health care organizations don't often consider relative performance when setting executive pay. Board compensation committees are beginning to ask, "If we pay at a certain level, what is the relative performance we should expect from this executive team?" The example below provides a graphic representation of one approach to gauging the alignment between pay and performance.

Figure 1: Competitive Pay vs. Relative Performance



In the example illustrated in Figure 1, the relationship between pay and performance is ideally aligned in the upper-right quadrant, which represents organizations performing and paying better than their peers. While aligned, organizations in the lower-left quadrant are both under-performing and paying less than their peers. Organizations in the lower-right quadrant should assess their executive retention risks while those in the upper-left quadrant should examine the return on investment on executive compensation. Aligning pay with performance is a well-established practice in the for-profit world. With the relative performance data that have become available over the past several years, health care organizations now can and should consider how to better align pay with performance.

A Fresh Look at Long-Term Incentive Plans

Long-term incentive plans allow organizations to distinguish between objectives that drive annual operating performance and long-term goals and are intended to transform the organization over an extended time period. Long-term incentive plans provide a direct link between executive performance and achievement of transformational goals in the organization's strategic plan. In the past, the use of long-term incentives was limited to all but the largest health care organizations, but that practice is changing.

Today, setting and executing the right strategy is imperative. With so much at stake, an increasing number of organizations are considering long-term incentive plans as a means to tie executive pay to critical long-term strategies. Data from SullivanCotter's Manager and Executive Compensation in Hospitals and Health Systems Survey (2014) indicate that the prevalence of long-term plans in health systems grew from 18% in 2012 to 29% in 2014. For systems with more than $3 billion in net revenue, the prevalence has grown from 17% in 2012 to 57% in 2014.

A key consideration for board compensation committees in organizations with long-term incentive plans is whether the award opportunity levels in the annual and long-term incentive plans are properly balanced. With the increased importance of developing and executing a strategy that will position an organization for future success, it may be time to reconsider the balance. Today, re-balancing is primarily taking the form of enhanced long-term incentive opportunities, thereby creating more leverage. In the future, we may see more money shifting from the annual plan to the long-term plan without necessarily increasing the total value of the package.

For decades, for-profit organizations have been tying executive pay to the creation of enterprise value and paying awards at the back end, when that value is realized. Clearly, value is different in not-for-profit health care – it's not shareholder return, but rather the successful execution of a transformational strategy to meet the organization's mission. Board compensation committees in not-for-profit health care organizations will need to focus on defining "value" and determining how "value creation" will be measured and rewarded. Beyond traditional balance sheet and income statement measures

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defining economic value, health care organizations may begin to emphasize value from the perspective of the communities and the populations they serve. Accordingly, metrics reflecting total community benefit (e.g., charitable and discounted care), economic impact and population health and wellness could become common metrics in long-term incentive plans.

As organizations examine the appropriateness of long-term incentives, one of the key considerations for board compensation committees is plan structure. There are several alternatives with varying degrees of complexity, each having distinct advantages and disadvantages. As illustrated in Figure 2, one common type of plan starts a new performance cycle annually with a new set of goals (A), and after a few years, the overlapping cycles create the potential for payouts annually (B).

Another type of plan starts a new performance cycle (A) only upon completion of the prior cycle, with the payout opportunity at the back end (B) as illustrated in Figure 3.

The decision on plan structure – whether it's overlapping cycles, end-to-end plans or some other variation – should be driven by what best fits the strategic plan and not necessarily by what is prevalent in the industry.

Driving Success

Aligning business goals with executive incentive plans requires correctly balancing the reward potential linked to annual goals and long-term objectives, using the right incentive plan structure to achieve both annual and long-term goals and selecting the appropriate metrics to drive performance. Compensation practices can be borrowed from the for-profit sector – putting more pay at risk, tying pay to key long-term objectives and paying rewards at the back end upon completion of major initiatives. It's important that board compensation committees understand where executive pay is positioned relative to peers, as well as how hospital or health system performance compares with that of peers.

As the market continues to transform, health care organizations will adopt new business strategies to meet market challenges. Incentive plans must adapt as well. Governing boards and compensation committees that understand the need for these shifts will reshape their current incentive plans to meet both the requirements of an evolving industry and the short- and long-term goals of their organizations.

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Figure 2

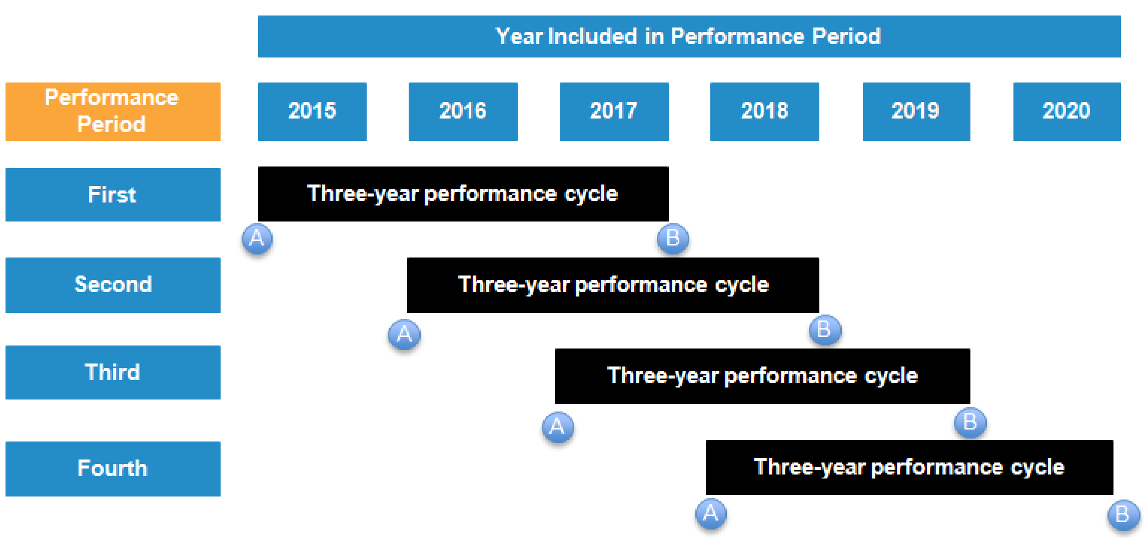

Figure 3