

Executive Compensation and Governance Considerations for Health Systems

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Health systems continue to face a difficult environment. While operating margins for the overall industry have shown some modest improvement in early 2023, the long-term financial outlook remains challenging due to increased costs of labor, supplies, and borrowing, as well as ongoing revenue pressures due to service mix changes, access limitations, and volume shortfalls. Concurrently, the demand for executive talent is high due to the departure of experienced leaders and the evolving skills needed to manage increasingly complex operations and changing care delivery models. Consequently, there has been ongoing upward pressure on healthcare executive compensation, despite the challenging financial environment.

Against this backdrop, the scrutiny of executive compensation within not-for-profit health systems is intense. The Federal Trade Commission (FTC) is considering limits on the use of non-compete clauses, the Department of Justice (DOJ) is encouraging links of compensation to compliance, and the media, elected officials, and other stakeholders are questioning compensation levels.

Compensation committees are balancing these financial, operational, talent, and governance risks on their performance and in their executive compensation program. This article summarizes the priorities that health systems and their compensation committees should consider for the rest of 2023 and beyond.

Key Priorities

1. *Reward Differentiation*

Optimizing the organization's compensation investment is particularly important given the industry's financial challenges:

- **Provide flexibility in the compensation philosophy:** Three areas should be considered for the compensation philosophy to optimize rewards spend: 1) reference a range of market competitiveness (e.g., 50th to 75th percentiles)

rather than having one target percentile for all executive roles; 2) provide peer references outside of not-for-profit healthcare when needed for particular roles (e.g., general industry, managed care); and 3) allow for the use of individually tailored programs when needed (e.g., individual retention awards).

- **Direct rewards to high performers and critical positions:** Ensure the differentiation of rewards for top talent. Provide market adjustments to salary to improve competitive positioning. Utilize an incentive program to recognize strong performance through discretionary awards beyond the plan formula.
- **Tailor programs for non-traditional operating segments:** Consider whether a different compensation program is appropriate for select operating segments, such as commercialization businesses, investment functions, and health plans.

2. Talent Strategy and Alignment

The competitive talent market reinforces the need to build talent from within and to optimize the leadership structure:

- **Assess the leadership structure:** Organizations should evaluate the leadership structure to ensure it is optimal for its operations. In SullivanCotter's April 2023 Executive Compensation Pulse Survey of 108 large health systems, about three-quarters of respondents indicated that they are taking actions around their leadership structure. Priorities include a review of leadership headcount, distribution of roles by level, management layers, titling guidelines, and spans of control. Leveling guidelines should be reviewed to support talent development and integration.
- **Conduct regular talent assessments and refresh development plans:** Ensure that there is a robust process for regularly assessing leadership to identify high performers and high potentials. Prepare and regularly refresh development plans to support career advancement.
- **Review succession plans:** Embed succession planning into talent development. Ensure that emergency and permanent succession plans are in place. Identify gaps and determine actions, including internal development, external recruitment, and role redefinition opportunities.
- **Evaluate and mitigate talent risk:** Assess potential retention risks of critical leaders. Determine mitigation strategies, including compensation actions and professional development plans.
- **Integrate diversity, equity, and inclusion (DE&I):** Ensure that DE&I is incorporated into all aspects of talent planning, including leadership development, talent sourcing, pay equity analyses, and organizational structure assessment.

3. Incentive Plan Effectiveness

Examine the executive incentive plan to ensure rewards are appropriately aligned with performance:

- **Focus on key performance priorities:** Ensure that incentive goals reflect critical priorities that align with the health system's evolution. Goals of particular focus include cost efficiency, quality, workforce engagement, access, growth, and patient satisfaction.
- **Account for uncertainty in goal setting:** The uncertain and volatile environment creates challenges for performance forecasts. Consider the use of relative performance indicators, validate that the range of performance standards for threshold/target/maximum reflects current uncertainties, determine if milestone goals are appropriate, and assess if the performance period for goals should be shortened (e.g., using two six-month goals rather than a 12-month goal).
- **Verify incentive performance standards:** Performance standards should reflect appropriate improvement over the baseline and goals that are attainable while representing a reasonable degree of stretch.

4. Governance

Compensation committees will likely continue to exercise business judgment as pay actions are determined. Consider the following:

- **Be flexible:** Balance performance, market uncertainty, and the competitive talent market as decisions are made on performance goals, incentive awards, and compensation adjustments. Prepare to apply discretion when necessary to ensure that recruitment, retention, talent development, and performance needs are met. Consider the development of guidelines to structure the application of discretion.
- **Prepare for potential scrutiny:** The compensation committee should be apprised of and consider the implications of potential scrutiny. Compensation committees should assess the impact of the DOJ's rules to encourage links of compensation to compliance, the FTC's proposals to limit the use of non-compete clauses, state actions around pay transparency, and media and other stakeholder scrutiny. Undertake a review of the executive compensation program attributes, plan design, employment and severance agreement terms, and policies/practices to determine if adjustments are needed. Update the board on the executive compensation program and governance process to ensure that all members are aware of the organization's program and practices.

- **Understand implications for staff and physician compensation:** Consider receiving educational updates on broader workforce implications as part of enterprise risk management activities. Determine whether changes to physician compensation oversight are required.

→ Key Considerations for Compensation Committees

Not-for-profit health systems are facing a difficult environment. The financial outlook is challenging and there is uncertainty about the future. Concurrently, the demand for executive talent is high, and compensation levels have been increasing. Against this backdrop, the scrutiny of executive compensation is intense.

Compensation committees and health system leaders are balancing these financial, operational, talent, and governance risks in their executive compensation program. Compensation committees should consider four priorities:

- **Reward differentiation:** Provide flexibility in the compensation philosophy, direct rewards to high performers and critical positions, and tailor programs for non-traditional operating segments.
- **Talent strategy and alignment:** Assess the leadership structure, conduct regular talent assessments and refresh development plans, review succession plans, evaluate and mitigate talent risks, and integrate DE&I in talent strategy.
- **Incentive plan effectiveness:** Focus on key performance priorities, account for uncertainty in goal setting, and verify incentive performance standards.
- **Governance:** Be flexible, prepare for potential scrutiny, and understand the implications for staff and physician compensation.

By being vigilant about monitoring the environment and regularly evaluating and refining compensation programs and governance, compensation committees and health systems can ensure that the program supports executive recruitment, retention, and performance.

Conclusion

Compensation committees and health system leaders face a challenging environment that requires balancing the competitive executive and clinical talent market with a volatile and uncertain performance environment, changes to clinical delivery models, and increasing scrutiny of executive compensation. Committees are well served to regularly review the executive compensation philosophy and program, performance goals, talent strategy, and governance practices to ensure that recruitment, retention, and rewards objectives are met and that the program is beyond reproach if scrutinized.

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