Examining the Implications of Increasing Executive Pay Scrutiny

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Many not-for-profit health systems nationwide have struggled to sustain or improve performance in recent years due to unprecedented financial concerns, workforce shortages, wage pressures, inflation, and other operational issues. In addition to addressing operational performance, health care organizations are growing considerably more complex as they consider options for continued growth, diversification of revenue, and optimization. As a result, the executive talent market remains highly competitive as the demand for leadership with the necessary skills and experience to lead through such unprecedented times continues to outpace supply.

This is driving up executive compensation in an already competitive market. Against this backdrop, broader issues of patient access and affordability, the ability for employees to earn a living wage, ongoing government deficits, and the current political environment are fueling scrutiny of the health care delivery system. **Executive compensation is front and center in these discussions:**

- Lawmakers, unions, and the media continue to focus on the **ratio of CEO pay to the average worker.** While not specific to not-for-profit health systems, it highlights the broader dialogue around the relationship between executive and broader workforce compensation.
- **Ballot initiatives** are also being introduced to limit hospital executive pay. For example, a ballot initiative had been introduced in Los Angeles on whether or not to cap the total compensation of executives, managers, or administrators at local privately owned hospitals at $450,000.[1]
- **Pay transparency laws** are on the rise - requiring organizations to post pay ranges for employment opportunities. Several states already have such laws, while many others are considering or intending to follow them. Federal pay transparency legislation is also pending.[2]
- The relationship between the **public charity provided by not-for-profit health systems and tax-exempt status** is being examined by the media and state and federal legislators. In October 2023, the Senate Health, Education, Labor, and Pensions Committee issued a report citing limited charity care provided by not-for-profit hospitals relative to organizational revenues and CEO compensation.[3] As another example, the state court in Pennsylvania has challenged real-estate tax exemptions.[4]

While the Boards of not-for-profit health systems have long overseen executive compensation consistent with accepted best practices and governance standards, continued scrutiny may present greater risks for how executive compensation practices are perceived. Executive compensation practices deemed unreasonable or unfair may raise compliance concerns, increase reputational risk and influence consumer preferences, exacerbate workforce tensions, be leveraged by unions in organizing efforts and contract negotiations, and motivate elected officials and regulators to influence broader health care policy.

As such, the Compensation Committee must ensure that executive pay programs are reasonable, responsible, and sustainable while supporting recruitment, retention, and performance needs in a dynamic labor market. This requires considering the executive compensation philosophy, program, and pay decisions more broadly across multiple perspectives beyond market competitiveness.

TAKING A BROADER VIEW OF EXECUTIVE PAY

By adopting a more holistic, data-driven approach to reviewing and refining the executive pay philosophy, designing the executive compensation program, and effectively assessing and governing pay decisions, Boards and Compensation Committees can ensure that executive rewards programs remain highly defensible and beyond reproach as market conditions evolve, new risks emerge, and organizational dynamics shift.

Below are several key considerations for management and the Compensation Committee to address as part of an ongoing process to ensure alignment of executive compensation with the organization's mission, while also meeting objectives related to recruitment, retention, equity, affordability, and performance.

Performance:

Aligning pay with performance has long been a cornerstone of executive compensation programs. Within not-for-profit health systems, the use of incentive-based compensation is the norm. To help support defensibility, organizations should clearly define performance objectives and demonstrate a strong connection between executive compensation and organizational performance.

- Do our incentive plans reflect the organization's key operating and strategic priorities?
- Do our incentive performance goals represent an appropriate degree of stretch so payouts are commensurate with performance outcomes? Have we externally validated the performance standards to ensure they are meaningful?
- Do we consider our organization's relative performance versus peers when determining incentives?
- Does our competitive positioning of pay align with the organizational performance?

Mission:

Tax-exempt health systems are responsible for showing how they serve the broader public good. Some external stakeholders have questioned the appropriateness of tax-exempt status by citing high levels of executive compensation in relation to community benefit. While 'community benefit' is not well-defined, it calls into question an organization's overarching mission, vision, and values and whether it effectively serves the community in which it operates. Compensation should be evaluated in the context of how well the organization fulfills its mission.

- How do we define if we have succeeded in our mission? Do our performance-based incentive plans effectively align with our mission, vision, and values?
- Are there specific measures that should be incorporated into our incentive program to ensure a positive impact on the broader communities served? Are there opportunities to incorporate other attributes of our mission in the compensation program (e.g., education, research)?
- How does the compensation structure balance financial results with other performance measures aligned with our mission?
- Should we consider having specific measures related to community benefit or other impact in our incentive programs or as a funding trigger?

Market Competitiveness:

Offering competitive compensation ensures the organization can secure skilled and experienced executives. This is not just about where pay is relative to peers but also about ensuring that executive compensation and benefits programs are contemporary and effective in achieving their objectives.

- Are current compensation levels aligned with the competitive targets articulated within the philosophy?

- Should we segment our compensation philosophy to articulate different market targets for different roles or businesses based on their criticality to the mission?
- What mechanisms exist to regularly review and update compensation programs to maintain relevance and effectiveness?

Talent Strategy:

As the scope of responsibility widens and organizations continue to diversify their business strategies, the need for broader skill sets has expanded the search for executives beyond the traditional health care market for select positions. Furthermore, given a constrained talent market, succession and talent management plans are being adapted to mitigate risk during an unplanned transition and identify leadership deficits in key strategic areas. Comparing to the right peer groups can help ensure that the compensation program supports the organization's growth and enables it to effectively recruit and retain its executives. Furthermore, given certain financial constraints, directing compensation to high performers or potential successors is critical.

- Do our compensation peer groups reflect where we source executive talent? Does this differ for certain positions and areas of the business?
- How are we mitigating talent risks to ensure we retain the talent we have and plan for the talent/skills we need? Is our succession planning process sufficiently robust?
- Do our programs allow for adequately differentiating between high-performing and high-potential talent?
- Are we optimizing the use of our compensation spend? Are we directing differentiated pay to the roles and incumbents that are most critical, highest performing, and most likely to impact the success of our mission?
- Have we reviewed the collective holding power of various compensation programs to understand how such programs support executive retention?

Efficiency:

With changing care models and greater pressure on financial performance, health systems must look more holistically at their leadership structure to ensure it is optimized for operational excellence and supports cost efficiency. This includes examining headcount, spans of control, and the titling/leveling distribution across the organization.

- What is our total expenditure for the executive rewards program?
- How does our overall executive leadership count and spend compare to peers?
- Is our leadership structure optimized for growth and efficiency? Is it aligned with the capabilities and processes needed to optimize the impact we have on carrying out our mission and impacting the communities we serve?

Equity

Equitable pay practices are crucial for attracting and retaining top-tier talent by demonstrating a commitment to fair rewards for all leaders, regardless of age, race, or gender. This applies to how similar leadership roles are paid in relation to each other and includes how pay practices and policies align across the organization's entire workforce. While this does not imply that all programs must be employed universally across the organization, it does suggest that similar guiding principles are applied to all compensation decision-making.

- Have we conducted a formal pay equity analysis?

- How do our executive compensation pay philosophy principles align with the broader workforce? For example, are the peers, compensation and benefits program attributes, and market targets appropriate across workforce cohorts? If they are not consistent, can we clearly articulate why?
- Are our rewards programs designed fairly to deliver comparable value and benefits for leaders at similar levels across the organization?

Committee Transparency and Compliance:

Organizations must remain actively engaged and vigilant. This includes ongoing education on industry trends and regulatory developments. It also includes reaffirming the Committee's role, evaluating its performance, and regularly updating the Board on compensation decisions, compliance initiatives, and policy changes.

- Have we revisited our governance process to ensure proper oversight and alignment with regulatory requirements?
- Are we conducting regular committee education and orientation?
- Is the full Board appraised of the executive compensation governance process?
- Are we keeping abreast of emerging market trends and best practices?
- Do we have a media strategy to respond to scrutiny and communicate executive compensation decisions to key stakeholders?

CONCLUSION

As health systems realign their strategic objectives within a rapidly changing health care environment, executive compensation programs are evolving in kind. Increasingly, this evolution includes developing a more holistic executive compensation program that optimizes total expenditure while balancing key considerations such as pay competitiveness, talent strategy, mission alignment, performance and equity.

Scrutiny of executive compensation – from the media, regulators, and other internal and external stakeholders - is expected to persist amidst ongoing financial pressure while competition for talent increases and compensation levels grow. To help proactively mitigate potential risks associated with this heightened level of scrutiny, it's important to ensure that the compensation program aligns with the organization's mission and is highly defensible and beyond reproach. While competitive pay is important, this requires a more holistic and balanced review of multiple dimensions embedded within the Compensation Committee's ongoing process.

Sources:

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