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What to Watch This Year: Executive Compensation Alignment and Board Development

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Change is the only constant when it comes to the healthcare industry. Many had hoped for some clear direction with regard to the Affordable Care Act (ACA) in 2017 that didn't materialize, and as we kick off 2018, large-scale mergers such as Aetna and CVS offer the potential for new, further disruption.

Nevertheless, the industry has proven adept at moving ahead with transformation strategies in the face of uncertainty. The view that executive compensation—and particularly the use of long-term incentives—can be a tool to enact strategic business changes is taking hold, and boards of directors are rising to the challenge of guiding their organizations in entirely new directions.

As we look at the unique challenges this industry poses, there are two key areas for directors to watch this year: the alignment of funding models and long-term incentives and the maturing of board governance.

Alignment of Funding Models and Long-Term Incentives

While various legislative efforts seem to change by the day, there is little disagreement that there will be continued diminishment of funding for Medicare and Medicaid. Provider organizations whose patients are more reliant on these programs are already challenged to provide their boards with operating budgets above breakeven.

Healthcare providers serving patient populations with a mix of employer-provided and commercial insurance plans are also feeling the pinch. However, they can more often generate some sustainable margin that can be invested in new or expanded lines of business with more favorable anticipated reimbursement rates, such as ambulatory care, behavioral health, partnerships with other types of providers enabling bundled services, etc.

It's in this tough budget environment that all healthcare providers, regardless of their place on the reimbursement continuum, have a common need to recruit, motivate, and retain quality leaders from among a limited pool of candidates.

Given the complexity and long-range nature of healthcare business strategies, there have been two noticeable changes to traditional executive compensation practices in the industry: 1) a greater reliance on variable compensation and 2) an emphasis on long-term incentive (LTI) plans. Boards are finding that LTIs can enable them to more broadly recruit based on potential high-end levels of pay, can provide a retention vehicle for successful executives, and when properly designed, can drive meaningful improvements to the new "Triple Aim" strategy of improved efficiency, quality, and patient experience. However, to be most effective, these long-term incentive plans may need to emphasize one factor over another, as determined by the organization's primary reimbursement.

Those hospitals and health systems more reliant on Medicare and Medicaid are quite often safety-net providers in the community and are not necessarily challenged by the need to grow market share as much as the need to evolve more efficient and effective ways of treating the flow of severe, often chronic cases they encounter on a daily basis. Their LTIs may emphasize driving cost out of the delivery system, while demonstrating levels of quality sufficient to maintain their reimbursement eligibility against CMS-mandated thresholds. They must also address patient experience, and may choose to establish or revitalize an existing patient rating program, which allows their patients' ratings of their experience to be compared against other providers. Patient experience may be established as a factor in their annual incentive plan or as a long-term incentive metric or plan modifier.

In contract, the strategy of many providers whose current and prospective patient populations are more likely to participate in commercial health insurance plans is to grow that patient demographic and market share. Critical to that goal is the organization's ability to demonstrate extremely high levels of clinical quality and patient satisfaction over a sustained period of time. As in many industries, achieving consistent high quality in direct care requires that it be built into the core culture of the organization, which is a multi-year proposition.

These organizations may establish LTIs driven by some mix of growth and clinical quality, so that their ability to increase either of the two can increase the other, as well as patient satisfaction. Since they must also address efficiency to preserve their ability to invest in growth opportunities, they may choose to also establish some measure of operating margin or earnings as funding mechanism for the overall incentive program.

In general, LTIs are more likely to be established at larger organizations than smaller; however, there is no reason for smaller mid-market provider organization to forego a long-term incentive plan in an effort to align strategy and pay. The key to successful implementation is a clear articulation of long-range strategy and mission, and translation of that vision into quantifiable and understandable measures and metrics. Also important is the calibration of long-term (and short-term) incentive award opportunities with proper competitive market positioning. For-profit and non-profit boards alike should closely monitor their executive compensation programs to ensure reasonableness of total compensation based on performance, as well as transparency to participants, regulators, and the communities served.

Maturing Board Governance—Transparency and Teamwork

Providing effective governance is the key responsibility for any board of directors. In most industries, for-profit directors typically have experience with the type of company on whose board they serve and their background allows productive engagement in their fiduciary and strategic responsibilities. On the other hand, boards of non-profit organizations are often comprised of successful local executives, business owners, and civic leaders who may or may not have direct experience in public company governance or the organization's mission, but their networks and leadership capabilities serve those institutions well.

Boards in the healthcare industry, however, may or may not fit either of these norms and regardless of their experience, may be struggling to provide proper oversight because of the unique challenges of the industry, such as quickly evolving business strategies, emerging practices in executive compensation, and uncertain or inconsistent funding scenarios.

As an example, consider that industry veterans are now often appointed to for-profit healthcare boards due to their expertise in *adjacent* industries like insurance, hospitality, or retail, as those new skills are now needed in the healthcare space, but they may lack medical or healthcare administrative experience. Another scenario can include not-for-profit directors, who, because they are typically stewards of taxpayer or charity dollars, may have a rightly-held predisposition to very conservative budgeting. While a benefit in most non-profits, that experience could have the unintended consequence of holding up the investment in and advancement of needed new healthcare strategies.

Today's healthcare CEO—who increasingly brings a strong mix of medical and administrative acumen to the job—can play a large role in helping the board help the organization. Likewise, the board may bring the business and financial insight that can help management make better informed key strategic decisions. Both sides' abilities to participate in a meaningful dialogue will only improve with knowledge gained from the other.

To the extent that the board can establish an environment of trust with their CEO, he or she may feel more comfortable providing some valuable education regarding shifting payer and care delivery issues, and the organization's strategic initiatives that are in place to address myriad financial, quality, and patient experience challenges. Transparency concerning these challenges, and the organization's chances of success, will only occur when management believes there will be benefit to educating directors, and when the board is open to learning and applying medical and healthcare administrative knowledge to their business or non-profit management experience.

Further, as boards recruit new directors, they should understand whether there are missing skills or talents, in addition to evaluating candidates against some important broad factors:

- **Passion**: An ideal director will be passionate about the mission and purpose of the organization they serve.
- **Diversity**: It's become increasingly important for senior management teams and boards to have a range of points of view in order to best navigate complex issues and serve varied populations.
- **Experience**: Significant leadership experience tends to mold the most effective board members.
- **Executive/professional skills**: It's vital for boards to have a few individuals who have specific skills and experiences to guide complex legal, financial, or business issues. Some of the most critical skills are finance, accounting, audit, risk, marketing, IT, HR, and legal.
- **Availability**: An ideal board member will be able to make a serious time commitment to actively participate in both board- and committee-level work, including meeting preparation and attendance, as well as special projects/initiatives throughout the year.

Across all industries, there has been a steady increase in the time commitment and amount of activity and strategic work that is needed at the full board and committee levels. The changing skill sets required for effective oversight in the industry point to a related consideration for healthcare boards: compensating their directors. This is a common practice among not-for-profit and for-profit insurers but is uncommon among not-for-profit hospitals and health systems. According to The Governance Institute's 2017 biennial survey, 12 percent of hospitals and health systems compensate the board chair and 11 percent compensate other board members.[1]

[1] Kathryn Peisert and Kayla Wagner, *The Governance Evolution: Meeting New Industry Demands*, 2017 Biennial Survey of Hospitals and Healthcare Systems, The Governance Institute.

Correlating with the demand for top-level talent and the director's workload is the need to ensure that board compensation programs for those that do pay their directors are competitive with the market. Both not-for-profit and for-profit healthcare organizations that pay their boards conduct periodic assessments of board compensation relative to other similar organizations and make adjustments as needed to ensure they can continue to attract and retain high-quality director talent with the backgrounds and experiences that the board requires.

Looking Forward

While stability and predictability in the industry may not yet be in sight, providers and insurers are adapting to the realities of an uncertain healthcare environment. As they seek out new strategies and tools to manage the business of healthcare, board governance and executive compensation programs can have an increasingly influential role in this transformation.

The Governance Institute thanks Steven Sullivan, Principal with executive compensation consultancy, Pearl Meyer, for contributing this article. He can be reached at steven.sullivan@pearlmeyer.com.