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Revisiting Executive Incentive Compensation: A New Challenge

Incentive compensation plans are intended to focus executives' attention on their organizations' most vital priorities and initiatives. As health care organizations revise their business strategies to address the ongoing transformation of care delivery and payment, health care boards also need to reassess the structure and measures of performance in their executive incentive compensation plans. Such an assessment can help to determine whether incentive plans and executive performance are aligned with a health system's current goals and the changing marketplace.

WHERE WE'RE GOING AND WHY

The prevalence of incentive compensation arrangements is growing among nonprofit health care organizations as they consolidate, integrate, and grow in size and complexity. More executive pay is being put at risk, and boards are expanding the types of measures they use to evaluate executive performance.

Annual incentive compensation plans have traditionally focused on rewarding operational performance, of which a primary component has been financial results. There is no question that financial performance is integral to the ongoing viability of the organization and its ability to invest in the future and meet its nonprofit mission. However, organizations are finding themselves in a position where resources must be expended to execute long-term strategies, which may affect short-term financial results. In these cases, emphasizing measures of annual financial success in determining executive compensation may not be the right recipe for success. Specifically, these organizations often grow in size and scale as part of multiyear strategies to simultaneously address a variety of environmental factors that impact organizational performance [see Change Agents, Page 18].

Boards can benefit from reviewing the areas of performance their executive compensation plans are measuring and how measurement and rewards are structured. The aim is to ensure that these plans truly focus on driving achievement of both short- and long-term critical organizational goals.

Sullivan, Cotter and Associates Inc. conducted a study of chief executive officer annual incentive compensation practices over the past four years in more than 50 large, nonprofit hospitals and health systems to gain insight into relationships among performance measures; the weights they are given; and quality, patient experience and financial outcomes they generate. Findings indicate a shifting playing field on which health systems are attempting to juggle a growing number of priorities, as reflected by the types of incentive plan measures now being used [see Top 14 Performance Measure Categories, Page 16]. These priorities suggest the need for a dashboard of organizational performance measures that goes beyond the traditional focus on finance, quality and satisfaction that boards generally have used to set executive incentive compensation. Boards and their executive compensation committees may be concerned that adding different types of measures to rate CEO performance will come at the expense of keeping an eye on the organization's financial performance. However, study results indicate otherwise.

PEOPLE, PROCESS AND OUTCOMES

SullivanCotter's review of performance in large health systems indicates that an increased focus on patient satisfaction in the CEO's annual incentive plan has a positive correlation to the organization's profitability. Additionally, the relationship between employee engagement and satisfaction and financial perfor-

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mance appears to be even stronger.

Study findings show that organizations that place more weight on performance measures related to human resources (or people measures) when determining CEO annual incentive compensation have better year-end net patient margins than those with lower weights [see CEO Incentive People Measures, right]. Organizations that focus specifically on three or more patient satisfaction measures in the CEO's annual incentive compensation have higher patient satisfaction ratings, as well as better financial health. In addition, patient satisfaction and the rate of core measure adherence increase when an organization's workforce is engaged in providing a better care experience for patients.

A more rigorous focus on patient satisfaction measures in evaluating executive performance also improves an organization's ability to identify which entities or departments are having the greatest impact on patient satisfaction. This capability supports shared learning about successful practices that can help to increase patient satisfaction throughout the organization.

CEO Incentive People Measures

- Employee satisfaction or engagement
- Physician satisfaction or engagement
- Employee wellness initiatives
- Reward programs
- Staff retention or turnover
- Achievement of diversity goals
- Use of leadership development and succession planning

Top 14 Performance Measure Categories

A recent review of 2,300 distinct performance measures used in chief executive officer short-term incentive plans in more than 50 large nonprofit health care organizations resulted in 14 overall categories of measures. They are listed in order of most frequent to least frequent use:

1. **Finance**
2. **Quality**
3. **Patient satisfaction**
4. **People (employees)**
5. **Growth**
6. **Efficiency**
7. **Continuum of care**
8. **System infrastructure or integration**
9. **Other**
10. **Community benefit**
11. **Philanthropy**
12. **Discretionary**
13. **Individual measures**
14. **Research or teaching**

Source: Sullivan, Cotter and Associates Inc., 2014

While all organizations must take into account their own unique strategies and markets in establishing performance measures for incentive plans, focusing on people, process and outcome performance measures is a rational response to a changing, tumultuous environment. Improving patient, employee and physician satisfaction can provide a positive counterbalance to the host of other factors, such as unpredictable revenue, cost-reduction challenges, merger and acquisition activity, and major changes in payment and care delivery, that also affect the performance of today's health care organizations, in sometimes irrational or unintended ways.

BALANCING ACT

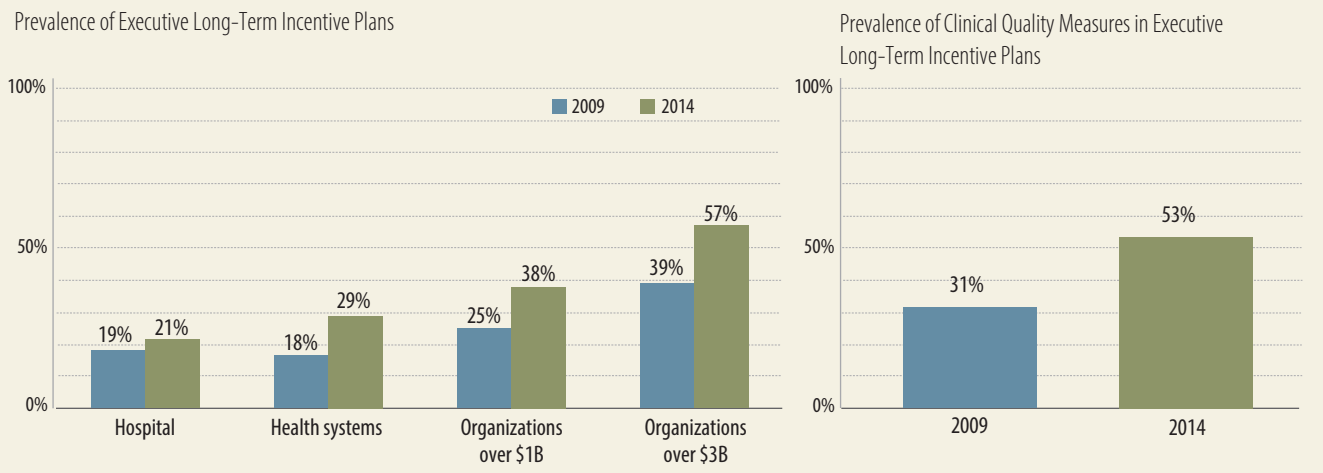
Nonprofit organizations are focused on strategic and mission performance and, as an industry, have embraced incentive-based compensation as a tool for achieving goals. The use of long-term incentive plans is growing, especially among larger organizations, according to SullivanCotter's 2014 Manager and Executive Compensation in Hospitals and Health Systems Survey [see Growing Use of Long-Term Incentive Plans, Page 17]. Last year, 57 percent of organizations with $3 billion or more in net revenue had long-term incentive plans in place for their executive team. And, short-term incentive plans are prevalent across organizations of all sizes.

Today's changing health care market is expanding the scope of performance goals for organizations to focus on and drive the development of new strategies to achieve multiple, complex goals. While some examples are physician integration, electronic health record implementation and development of an expanded continuum of care to manage population health better, each organization will set strategies and goals that respond to its unique circumstances and markets. Board compensation committees must, therefore, understand environmental trends to set the context for the development of performance measures for their executive incentive compensation plans.

SullivanCotter's work with hospitals and health systems also indicates a stronger focus on "systemness" that involves bringing all hospitals in a care system to an equal or common standard of performance or performance improvement, which typically takes several years to achieve. The drive toward systemness is one factor contributing to an uptick in the number of organizations using long-term incentive plans in addition to annual incentive plans. These initiatives take time, money and attention on the part of executives to get all parts of the system working toward aligned goals and objectives. However, because long-term incentive plans often are add-ons, board compensation committees may need to rebalance or change the level and weight of incentive pay elements among annual and long-term plans. This ensures that available resources are appropriately allocated to achieve key outcomes and that executive pay is fair and reasonable.

For example, the SullivanCotter study shows that, while still prevalent, the use of financial, quality and patient satisfaction measures is trending down slightly to make room for an increase in the use of performance measures around growth, managing integration and operational efficiency, and enhancing organizational image or reputation — often of par-

GROWING USE OF LONG-TERM INCENTIVE PLANS



Source: Manager and Executive Compensation in Hospitals and Health Systems Survey, Sullivan, Cotter and Associates Inc., 2009, 2014

ticular importance to academic medical centers.

Organizations that are comfortable interpreting their strategic plans and setting quantitative, measurable near- and long-term goals often can more easily set long-term goals for rewarding executive performance. However, boards and their executive compensation committees should keep in mind that the requirements for effective goal-setting within executive incentive plans remain the same: Goals must be clear, quantifiable and have the ability to be benchmarked. Long-term incentive plans often are three-year programs, but can vary between two and five years, depending on an organization's time horizon for goal achievement. These plans can be end-to-end or overlapping, depending on each organization's planning cycles, and need to reset strategic performance goals.

In our experience and review of large health system executive compensation practices, we have found that organizations that concentrate on a broad but focused spectrum of measures in areas that significantly affect their performance tend to work better collectively to obtain desired results. While commonly used performance measures relate to patient and employee satisfaction, finance, quality and safety, and growth or integration, the specificity of performance goals and determining what level of improvement is appropriate to expect over what time period is critical. Establishing effective executive incentive compensation plans often depends on having board members and executives consider historical performance, improvement data, peer comparisons, and internal and external benchmarks, as well as applying their own solid business judgment.

WHAT ABOUT DASHBOARDS?

While using a scorecard or dashboard of organizational performance measures to set annual and longer-term executive incentive goals is useful, boards should be flexible in determining what measures reflect changing market conditions and organizational priorities as well as the weight assigned to them. Executives' performance measures and goals should be individually designed, and boards need to factor in the impact of environmental change and market trends on performance. For example, in the midst of mergers and acquisitions or accountable care organization development, the executive's attention likely will be drawn in unanticipated directions that may require course corrections. Boards should take unanticipated factors into account when assessing their executives' performance and capacity to achieve strategic and incentive plan goals.

Board executive compensation committees must understand their organizations' short- and long-term goals, as well as changes in the broader health care landscape to establish and prioritize incentive performance measures. They also must analyze the design of pay programs and periodically re-evaluate them to ensure that they are placing the right emphasis on pay-for-performance measures. Performance should be evaluated at the end of the performance cycle to learn from the experience and establish goals for the upcoming cycle. Peer performance also should be considered in establishing benchmarks, where available or appropriate, for comparison purposes.

A fundamental shift is underway to reward value over volume and improve the health of entire populations of patients, which intersects with goals to enhance community benefit and improve community health. Today, achieving these goals goes beyond managing care delivery within health care organizations to influencing care in the home after a hospital visit or in nursing homes or other post-acute settings, which also affects the organization's bottom line.

Value-based care requires efficient delivery of high-quality care when needed, supported by earlier intervention through the use of prevention and

wellness initiatives to avoid or shorten hospital stays and reduce health care costs. While performance categories themselves may not change, the aspects of performance that are measured and rewarded will. Although health care may be one of the last sectors to make this shift toward value, change likely will be evolutionary. It will occur gradually as provider networks expand, quality outcomes are more aggressively pursued and value-based purchasing becomes more significant, shifting from a system of incentives to a system of risk. Considering these shifts in determining how health care executives are paid is one way to effectively support these transitions [see Growing Use of Executive Long-Term Incentive Plans, Page 17].

STEPS FOR BOARDS

Boards that are taking a fresh look at updating and revitalizing their executive incentive compensation plans first should understand environmental and market trends affecting incentive compensation [see Change Agents, above]. Then, the board's executive compensation committee should review and analyze the existing plan against its organization's operational and strategic imperatives. The results of this review can help boards to prioritize performance areas, set incentive compensation metrics and plan structures to reinforce priorities likely to have the greatest impact on organizational success [see 10 Executive Compensation Questions, below]. Seasoned trustees who bring diverse skills, experience and sound business judgment often are more equipped to assess both organizational and executive performance and compensation.

Change Agents: Market Trends at Work

Many environmental forces shaping health care delivery also are beginning to be reflected in measures of executive incentive compensation. Recognizing the larger influences can help boards to set more relevant metrics and adjust them as the health care playing field continues to evolve. The most significant drivers of change are:

• Mergers and acquisitions • Clinical integration • Physician employment
• Increased access • Population health management
• Shrinking reimbursement • Participation in health insurance exchanges
• Patients as educated consumers • Innovation
• Specialization to achieve differentiation
• Capability to improve community health and deliver greater community benefit

Source: Sullivan, Cotter and Associates Inc., 2015

10 Executive Compensation Questions

1. Are our executive compensation incentives designed to drive both the annual and long-term objectives of the organization?
2. If so, do we have the right balance between annual and long-term reward opportunities?
3. Are we adapting our executive incentive plans to the changing needs of the organization and the evolution of the health care industry?
4. Do our goals align with our operating plan and our strategic plan?
5. How do our executive incentive compensation and performance expectations align with peer organizations?
6. Do we use internal and external benchmarks to set performance goals?
7. How have we performed in the past? What do we need to focus on to achieve our strategic objectives and mission?
8. How much stretch is in our goals? What is the likelihood of achievement?
9. How does our board compensation committee define value, and how will value creation be measured and rewarded?
10. Who signs off on the goals each year? Does the full board see the goals and understand the impact that achieving them will have on the organization and executive pay?

Source: "Transforming Executive Incentive Compensation," *Great Boards*, winter 2014

Aligning organizational goals and strategies with executive incentive compensation plans requires finding the right balance between rewards linked to annual goals and rewards tied to long-term objectives. While setting stretch goals often is appropriate, boards should avoid both under- and overreaching goals to ensure a desired performance. Underreaching goals may be viewed as establishing a plan that is really not performance-based, but status quo. Overreaching goals may serve as a disincentive if results are impossible to achieve. Compensation committees also must find the right incentive plan structure to achieve both types of goals and select appropriate metrics to drive performance. Incentive plans should be reviewed critically to make sure they focus on achieving the organization's most critical operating goals and strategies.

Compensation practices that tie pay to achieving both annual and long-term objectives, put more pay at risk and pay rewards for achieving major milestones can help boards support their health care organizations' performance today and into the future. T

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