Pearl Meyer

ARTICLE | MAR 2021

This Year it Goes Beyond Healthcare Executive Pay: Top Five Concerns for Healthcare Boards in 2021

Ed Steinhoff

MANAGING DIRECTOR

Jim Hudner

MANAGING DIRECTOR

Alexander Yaffe

MANAGING DIRECTOR

Tim Dupuis

PRINCIPAL

Employers across the country faced unprecedented turmoil in 2020 and residual effects continue. This was spearheaded by the emergence of the coronavirus, followed closely by significant economic challenges and a renewed, but more passionate focus on racial and social equality. Healthcare has been among the industry sectors most impacted with a proverbial double whammy: an incredible strain and risk imposed on its workforce caring for those with the virus, and the curtailing of elective, non-urgent medical services. The result is an overwhelmed staff and management teams facing rising costs and lower revenues.

These persistent challenges have required strong executive leadership and a board ready to provide timely support and guidance in the face of great uncertainty. In doing so, healthcare boards—like boards among public and private companies—have seen their oversight expand into areas that may not have traditionally had board purview. In fact, expanding the role of the board, and in particular the compensation committee, into broader talent management issues has been trending upward for several years.

With an elevated risk of a disenfranchised workforce, as well as a more urgent need to ensure a work environment that embraces diversity and equality, we expect to see a continued expansion of the board's role in ensuring short- and long-term organizational success through the acquisition and retention of talent at all levels of the organization. And while we expect the board to assert itself in these complex workforce management matters, we expect that a collaborative and trust-based approach with executive leadership will yield the most positive results.

Within the context of greater board involvement and the reassessment of business and talent management strategies, accelerated by the impact of the pandemic, we expect the following to be key areas of focus in 2021:

- The engagement, retention, and mental health of the workforce;
- Business strategy, alignment of compensation, and financial recovery and transformation;
- Goal-setting for insurers;
- The need to more actively manage risk; and
- A focus on the post-COVID-19 renewal of the strategic board.

Workforce Health

Many of us continue to feel extreme levels of uncertainty and risk in our personal lives and, to varying degrees, in our professional lives. Nowhere are these two stressors more intertwined than in healthcare. Although it takes a back seat today to physical health concerns, as direct care staff, managers, and leaders continue to experience constant stress, lack of control, and daily changes amidst the crisis, we expect burnout, an associated exodus from the industry, and significant mental health issues to emerge. As leaders think ahead to all aspects of post-pandemic recovery, taking all-encompassing care of the workforce will be a primary next-stage issue.

Given the unprecedented challenges that care providers have faced, it is imperative the workforce receives special attention and recognition. Boards should be, if they are not already, clearly stating this expectation to senior leadership and monitoring "organizational health" measures like unwanted turnover, open positions, understaffing, levels of engagement, unionization initiatives, and mental health claims. The impact of the pandemic on the workforce as a whole, and the criticality of the workforce to any organization, elevate this beyond a moral concern. It is, at a most basic level, a risk issue.

At the leadership level, any ongoing talent development initiatives taking place—particularly in care provider organizations—likely focus on "normal" leadership skills and CEO succession planning. However, what will be needed in the very near future are leaders who recognize the value of building "softer" skills and capabilities throughout the organization, for example recognizing the value of those who excel at reducing stress and anxiety, and rewarding and advancing those who can become better coaches and supporters of their teams.

Boards should begin preparing for the fact that further and more significant investments of time and money will need to be made on workforce health issues and that those investments will need to be sustained over time in order to retain staff. This focus took root early in 2020 with numerous examples such as additional pay to those required to quarantine and not work to protect the public, coworkers, and patients; or "hero" pay, special bonuses, and/or enhanced hourly pay for critical shifts. These are assumed to have been temporary, episodic, and short-term. However, the longer-term questions about the healthcare employer's obligations to its staff, including mental health counseling and recovery support, wellness benefits, advanced safety processes, and more add significant new variables to a provider's total compensation plans and are demanding attention.

Business Strategy, Alignment of Compensation, and Financial Recovery and Transformation

When it comes to a typical total compensation approach, most in the industry understand that the best-designed incentive plans support their business strategy and annual and longer-term business goals. Some are also incorporating leadership strategies and goals, as well. Today, most healthcare organizations take a "balanced scorecard" approach to incentive plan design, in which measures reflecting performance in different aspects of the organization's operations are outlined and strongly complement one another.

For example, a large non-profit healthcare system may incorporate performance measures reflecting margin, operational efficiency (such as expense reduction), patient safety, and quality. Growth measures (defined in terms of revenue or patient volumes) may be used by organizations that have key growth initiatives as part of their business strategies, while other organizations might measure employee engagement due to the high correlation between employee engagement levels and patient satisfaction. In recent years, it has become a more prevalent practice for healthcare organizations to incorporate more strategy-based measures in their incentive plans to reflect organization-wide priorities such as expanding geographically, adding new service areas, building capacity in existing service areas, consolidating operations, or improving population health in areas served.

In the normal course of events, it is important to revisit these incentive plan measures periodically to ensure that they continue to align with the evolving business strategy of the organization. In today's volatile environment, as healthcare organizations are working through the severe business and staffing challenges driven by the ongoing pandemic, it is critical that incentive plan measures reflect—and indeed help drive—swiftly changing business priorities due to the financial, operational, and employee engagement/morale impacts.

2021 will be a continuation of the 2020 turmoil—another year that defies "business as usual" for healthcare, and many organizations are finding that shifts to business models and operations need to occur rapidly to ensure that the organization remains financially viable to serve its customers in a high quality manner. As a result of these changing business priorities, we expect that the use of strategic measures will increase in 2021. These measures will reflect and reinforce an organization's new direction and help it transform in ways necessary to survive and thrive going forward.

Along with the increased use of strategic or "transformative" measures, we also expect that healthcare organizations will increase the implementation of ESG (environmental, social, and governance) measures in their incentive plans, just as we have seen among companies across other industries. For healthcare industry organizations, current prevalent ESG measures include patient safety, employee health and safety, and employee engagement. Newer metrics might focus on areas such as leadership development; board, executive, or employee diversity; waste and hazardous materials management; climate change; and business ethics.

Selecting performance measures, while critical, is one piece of executive incentive plan design that must be accompanied by a second piece: robust goal-setting practices. One way to effectively set goals in this uncertain environment is to use a broader range for each measure at threshold, target, and outstanding performance than what might have been used historically. For example, if the typical performance range from threshold to outstanding was 40%, for 2021, a performance range of 60% might better reflect industry uncertainties and unexpected external impacts on business operations. This type of design has the effect of flattening the leverage curve within the incentive plan while ensuring that the plans continue to reflect the organization's pay-for-performance philosophy.

Another method for incorporating increased external uncertainty into incentive plan design is to use relative measures rather than absolute measures such that the organization's performance is compared with other similar organizations, at least where such external data is available, timely, and reliable, as organizations across the industry will likely be impacted similarly by external circumstances.

A final tool that compensation committees of healthcare organizations need not hesitate to use is their discretion to judiciously adjust incentive payouts that have been calculated formulaically. This may be required to ensure continued alignment of executive pay with overall business results.

Goal-Setting for Insurers

While the COVID-19 pandemic caused serious financial stress on most of the US healthcare delivery system, including hospitals and physician practices, many health insurers experienced significant increases to their year-over-year earnings. This was due at least in part to declines in elective care that reduced health care expenditures and increased enrollment in Medicaid as many Americans lost their jobs.

As a result of this relatively strong financial performance, most health insurers saw their 2020 annual incentive programs fund at or above target performance levels which allowed these companies to reward their executives and employees relatively well during a very difficult year and work environment.

Although most insurers' 2020 financial performance was relatively stable, the fact that the pandemic still looms makes forecasting difficult when it comes to setting financial goals for 2021. Many health insurers are focusing on underwriting gain or other profitability metrics, as well as growth either in terms of revenue or members as significant metrics in annual and/or long-term incentive plans. However, projecting performance levels around these types of financial metrics is difficult when there is still so much unknown about just how long COVID-19 will impact the everyday lives of people and organizations.

As with providers, insurers are also looking to set a wider than normal performance range. Another approach is to use performance ranges for threshold, target, and maximum performance levels, rather than using a single absolute value. For example, if a company is using member growth as a metric, rather than setting a target goal of growing membership by 15,000 lives, target performance can be classified as growing membership by 13,000 to 17,000 lives. This approach allows organizations to set appropriate performance levels, in situations where companies do not have the ability to be as precise as they'd like.

In addition to using financial performance metrics, we are also seeing a significant increase in health insurers including non-financial aspects of their mission into their incentive plans. Some of the most common metrics being used are quality of care, customer or patient satisfaction, community health, affordability of care, and diversity and inclusion. Diversity and inclusion, in particular, has become a leading topic in the board room, and some organizations are beginning to measure and include diversity and inclusion initiatives within either their annual or long-term incentive programs by setting goals around addressing systemic barriers (e.g., conducting annual pay equity reviews), increasing the diverse talent representation within the organization, and efforts around growing and developing diverse talent.

The Rise of Risk in Healthcare

Before the global pandemic, healthcare industry watchers saw larger health systems starting to engage in nontraditional and sometimes risky business ventures. The financial fallout from the coronavirus crisis accelerated and amplified the diminishment of acute care revenues which had already been underway for years. Healthcare market economics forced healthcare systems and hospitals to find economies of scale via consolidation with complementary providers and efficiencies via layoffs and discontinued services. Perhaps most importantly, providers started creating their own opportunities through proactive investing, acquisitions and by lining up interested parties. Health systems started initiating and brokering transactions through to completion. Today's examples are plentiful and include pharmaceuticals, medical devices, equipment manufacturing and owned health insurance plans.

Board directors must appreciate how the ongoing COVID-19 crisis is accelerating and redirecting the industry's ongoing transformation from single service fee to overall aggregate outcomes. It is no small ask that they have the conviction to initiate unprecedented changes to their organization's care delivery model along the entire continuum of care. These changes must also be executed against a backdrop of confusing federal, state, and local policies and in an extremely turbulent economy.

It sounds risky, particularly for an industry that might have the lowest risk tolerance of any. Historically, only safe, well managed organizations have been able to provide consistently high-quality medical care. Taking on enterprise and reputational risk does not go hand-in-hand with the industry's conservative culture. Healthcare boards in particular have operated as a slow and steady guiding hand. Focused on stability and reliability, they are known to give CEOs a fairly short leash. Accordingly, CEO and other executives' compensation arrangements are also notoriously "short leashed," that is, based heavily on base salary instead of pay-for-performance incentives.

Non-profit healthcare boards should neither impart limits or discipline on managers, or try to instill an entrepreneurial management culture. Rather, they must foster an atmosphere of trust with the executive team. Only then can management feel comfortable in helping trustees better understand the organization's challenges, its marketplace strategy, and anticipated but calculated risks. This trust enables board members to more confidently communicate to executives that the board "has their back" and understands the risks associated with the increased complexity of transformational change, and it may encourage board members familiar with corporate transactions to draw on their expertise to help guide the organization.

Similarly, health system executive pay design must communicate support and also a sense of opportunity. Just as businesses with more speculative business models tend to have the most leveraged compensation arrangements, so too must healthcare in the 2020s adopt a dynamic approach to variable pay. High-risk acquisitions of hospitals and other businesses are often complex and require long-term sustained focus. Successful execution of a deal or failing it can be of monumental importance to an organization's long-term success. The executive compensation program must align with the nature of the business by providing considerable upside through a more leveraged short- and long-term incentive program which also fits within the parameters of reasonableness.

Focus on the Post-COVID-19 Renewal of the Strategic Board

Prior to COVID-19, healthcare boards had generally spent some time on strategy discussions and internally debated the weight between future-looking strategy and historical reporting.

Now, the pandemic has highlighted each board's strengths and weaknesses. How organizations have been able to engage and adapt during this crisis, from the board, to leaders, to providers of patient care, will be under the microscope.

The post-COVID-19 atmosphere will be differentiated from the prior period by an array of new pressures and increased demands, which will further complicate decision-making and may challenge traditional models of healthcare governance. What steps can healthcare boards take to ensure that lessons are learned, not lost, and that their organizations have better agility in the future?

For many boards, the governance process includes, at a minimum, an annual self-assessment. Our anecdotal observations with healthcare clients over the last year have shown one of the key factors that differentiated the organizations that were successful in weathering the crisis from those that were less so seems to have hinged, in part, on an ability to actualize findings from the annual assessment. The boards that go beyond the evaluation process and make needed change often have more of the intangibles that lead to effective governance in practice. These boards could be relied upon when needed.

Put simply, under crisis we have seen the difference between strategic engagement and rubber stamps. Strong governance with broad and thoughtful engagement between the board, its committees, and executive leadership withstood the pressure of the crisis. The required focus could be spread more effectively to ensure a more robust and nimble response.

For the boards that want to increase their strategic focus and improve effectiveness, there are some crisis evaluation questions that can help frame your discussion:

- How do you assess your engagement through the crisis period?
- Were any strengths that you identified pre-COVID-19 (or would have in a formal review) helpful and were they in fact strengths?
- In what ways was the board lacking?
- Are there readily identifiable areas where you need to further strengthen governance?
- What skill sets were missing within the board and management leadership structure?
- Were committees staffed with the right mix of expertise and thought-provoking voices to manage immediate issues concerning the business, employees, patients, external relationships, and expectations of the public?

Additional questions can begin to flesh out the way forward:

- How will/should our experience with COVID-19 lead us to re-examine and/or reengineer specific areas of governance?
- Should there be a reconsideration of the topics evaluated in our board assessment, for example are we effectively evaluating resilience or our ability to be nimble?
- Do we need to reconsider governance structures, such as additional committees or integrated working groups to focus on key takeaways from COVID-19?
- Do we need to find additional skills and talents to take our board forward in a well-rounded and comprehensive fashion, such as expertise in finance, quality, access, IT, security, supply chain, public relations, etc.?
- Are we taking full advantage of the skills we do have?
- How can we further develop our group cohesion and effectiveness?

The board spends considerable time and energy on a wide array of topics, but without strengthening the governance muscles, directors lose the opportunity to make the best use of that time spent. Think of it not as evaluation but rather envisioning the board with strong governance, the ability to achieve consensus around specific areas of improvement, and a transparent action plan to improve overall board effectiveness.

The deliberate evaluation of the effectiveness and observations of pre-and-post COVID-19 governance frameworks through structured facilitated conversations and intentional study will begin to point the way.

Conclusion

As boards and management teams across the healthcare spectrum focus on becoming more strategic in the long term, from both a business and a human capital perspective, the more immediate need to emerge from the current crisis as a viable organization is evident. However, it will be through close attention to the workforce, aligning—and realigning as necessary—executive pay and strategic goals, and a careful analysis of business risk that organizations may indeed exit 2021 in a strong position, ready to move forward with industry transformation.

About the Authors

Ed Steinhoff is a managing director and consulting team leader at Pearl Meyer. In his management role, he oversees a team of senior compensation consultants in the execution of the firm's growth strategy and in the development of consultants at various stages in their careers. With more than 25 years' experience in executive compensation, Ed works with the boards of directors and senior management teams of public and private companies, ranging from small and middle-market firms to multibillion-dollar corporations, to design pay programs that drive business performance and value creation, secure high-performing executive talent, and meet both regulatory standards and stakeholder expectations.

Jim Hudner is a managing director and consulting team leader at Pearl Meyer. In his management role, he oversees a team of senior compensation consultants in the execution of the firm's growth strategy and in the development of consultants at various stages in their careers. He consults in the areas of total compensation strategy, executive compensation, compensation planning, base salary management, incentive plan design, and performance management. Jim brings more than 30 years of consulting experience to his position and has consulted with organizations in a wide range of industries including technology, higher education, healthcare, research organizations, financial services, and manufacturing.

Alexander is a managing director at Pearl Meyer. The former president and CEO of Yaffe & Company, he is a second-generation expert in executive compensation and has two decades' experience in the field. As the leader of Yaffe & Company, he oversaw its geographic expansion from 10 to 37 states, development of complimentary service lines, and worked with clients whose net revenues ranged from $10M to greater than $1B, allowing for a varied perspective in similarities and differences based on geography, size, and organizational design.

Tim Dupuis is a vice president at Pearl Meyer. Tim specializes in executive compensation and works closely with boards of directors and senior management teams to design executive compensation programs that are aligned with the organization's business strategies, aid in the attraction and retention of key executive talent, and withstand external scrutiny. He has worked with a variety of companies across many industries, ranging from small entrepreneurial firms to Fortune 500 companies, with a particular focus on manufacturing, financial services, healthcare, retail, and not-for-profit organizations. His areas of expertise include executive and board of directors pay competitiveness reviews and annual and long-term incentive plan design.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.