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Modernizing Healthcare Executive Compensation Plans: A Deep Dive for the Board

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Healthcare providers are in a period of crisis. To navigate through it effectively will require a multitude of intertwined changes by the leadership teams that play a critical role for each of their hospitals and health systems. Directors serving on compensation committees have the opportunity to play a strategic role in the attraction and long-term retention of a relatively limited talent pool of change-making individuals. This is no easy task. It requires healthcare system boards to think less abstractly about executive compensation plans, programs, and theory and instead focus on flexibility, communication, judgement, and people through the lens of retention and long-term rewards. Incorporating career, culture, and coaching—all controllable elements—into the larger executive development approach goes even further toward creating a team that can bridge to the future.

According to Kaufman Hall, in 2022 hospitals experienced negative operating margins in 11 of 12 months and barely eked out a 0.2 percent gain in December. While that is movement in the right direction, approximately 50 percent of hospitals still ended the year in the red. At the same time M&A activity continued, with 53 transactions recorded in 2022. This year, labor force issues remain a top concern. When determining incentives and rewarding for success against goals, compensation committee members have to balance the stress of factors such as these, which are outside the control of the management team, while also being sensitive to the operating condition of the organization today, and the need to achieve an improved position in the future.

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This article helps frame these reconsiderations in three buckets: compensation philosophy, performance-based compensation, and deferred compensation.

Executive Compensation Philosophy

For base salary, many organizations typically target in the neighborhood of the 50th percentile for an experienced, well-performing executive. Performance-based compensation plans often layer on top of the base, allowing executives to earn at higher percentiles. Is that design framework still reasonable?

First, an examination of peer groups and published salary data is warranted. A common approach is to utilize traditional, published survey data to assess the competitiveness of a compensation package, and possibly array the data in several ways to align total operating revenue, complexity, and/or organization type.

However, thinking more strategically about potential comparisons may uncover some useful information. For example, many organizations, given size or the fact that they recruit nationally, evaluate published national data, but a medium-sized rural health system of close to $1 billion in revenue calibrated their approach to market as they recruited a young, dynamic physician executive to serve as President and CEO. That analysis showed meaningful differences between the national figures and those that were more focused super-regionally. In this case, the super-regional data showed higher base compensation and total cash compensation that was modestly higher. This led the organization to reconsider the degree of leverage in the annual incentive plan and shift more to long-term outcomes in order to better align with peers.

Similarly, examining the slate of offered benefits may influence the attractiveness of an offer, particularly now and in healthcare when work/life balance, wellness, and mental health concerns are more than casual concerns.

Performance-Based Compensation

Over the last 20 years, annual variable performance-based compensation has grown exponentially. Depending on the analysis, approximately 65 to 90 percent of executives have some form as a component of the overall compensation package. Over that time, goal-setting has become more sophisticated, tightly focused, and predicated on outcomes as opposed to process measures.

Moreover, the intent of the programs is to align organizational performance with compensation. Over the last several years, the degree to which factors contained in the program are controllable by management has become a larger discussion. For healthcare providers, this has been even more acutely felt given the inability to affect prices or reimbursement—or a global health crisis.

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Prior to 2020, many organizations had specific financial triggers that if not met would cause the program to remain unfunded. During the pandemic, we saw many organizations take steps to loosen some of those restraints to recognize the impact of the pandemic and acknowledge other aspects of progress. These are positive developments for management and the board. (After all, you do not want your tax-exempt compensation program to be too reliant on financial outcomes for payment, lest you look too much like a for-profit entity and risk your tax-exempt status.)

Many hospitals and health systems are considering permanently modifying their annual incentive programs. Financial measures are no longer an off/on switch and viewed more as an important consideration left to the judgement of the committee. Other options include:

- Lowering the amount of pay at-risk;
- Shifting the at-risk compensation to be more long-term than annual, given the time horizon of many initiatives; and
- Taking a hard look at the established criteria compared to past performance and future expectations, given the extent to which the landscape has shifted.

If the key is to attract, motivate, and retain top talent, the program should be properly balanced between high achievement and facts on the ground. If the variable compensation program is highly leveraged and the metrics upon which it is based are unrealistic in light of the operating environment, the organization has increased the potential for negative effects on culture, morale, and ultimately retention. The experience with the pandemic has shown that boards inherently recognize the need to be nimble and ensure retention of the right people to avert burnout or early departures.

Deferred Compensation

Healthcare organizations have long used traditional deferred compensation to bolster retirement income and link the executive's future compensation to their commitment to the organization. Anecdotally, many CEOs insist that if not for robust retirement benefit plans, they might not have stayed in the role. Clearly, deferred compensation can be a helpful retention tool.

In the past, plans were designed with retirement in mind, but offered earlier access to funds to lessen forfeiture risk, manage optics, or avoid piercing excise tax thresholds. Today, both boards and executives are looking for opportunities to create longer-term value in a fiscally responsible manner.

Over the last three years, we have seen many organizations turn the traditional approach on its head in a number of meaningful ways to include:

- A focus on the anticipated benefit produced at the end of the period, rather than the contribution being made, which allows for a better understanding of what is accessible to the executives if they meet the vesting requirements laid out by the board;
- A re-emergence of using limited defined benefit strategies to ease one burden for executives in a volatile investment market; and
- Broader analysis of vehicles available for deferral to ensure that the board and executives have a better understanding of all options, benefits, and drawbacks.

It should be noted that deferred compensation is one area where the options for plan design are often misunderstood and can lead to less favorable outcomes.

Conclusion

In a challenging operating environment where strategic momentum can take years to be realized, maintaining an effective individual or group can be the difference between capitalizing on opportunities and failure. Since the pandemic we have seen an explosion of healthcare organizations looking to find creative and proven strategies to retain both experienced and high-potential talent in the face of any number of circumstances that might draw them away. This will accelerate as organizations continue to consolidate.

Can these technical steps related to compensation serve to limit our risk of talent flight—either to competitors or another less-volatile industry? Can they serve to simplify the current pay program and allow for greater impact? Might these steps allow the organization to strengthen its long-term stability and sustainability as a going concern or to be more attractive as a partner? Certainly, compensation plan design is not the only answer, but it is one important and impactful piece of the puzzle that may help retain and grow a change-making leadership team.

Key Board Takeaways

- Review your executive compensation philosophy:
    - Is compensation structured in a way that differentiates your organization from the competition for talent?
    - Are you appropriately evaluating peer data—national versus regional pay, the practices of direct competitors versus aspirational, etc.?
    - Does the plan design and committee application acknowledge the humanistic side of pay and benefits?
- Evaluate—and potentially rethink—the structure of performance-based pay:
    - Do our incentive programs reflect our operating environment?
    - What is reasonable to expect executives to deliver and over what time period?
    - Does annual pay-for-performance still make sense for our organization? What are the benefits or drawbacks to reconsidering annual pay-for-performance? How might that impact the other elements of the compensation plan design?
    - Do we have triggers in our plan design that should be re-evaluated?
    - How have our goals changed over the last five years? Has our performance been improving, declining, or constant?
- Do we need to shift some of our focus to a longer-term horizon? What are benefits to taking that approach?
  Dig into the details of deferred compensation programs:
    - When did you last conduct a thorough evaluation of your non-qualified deferred compensation programs? Do we understand how these plans operate, including public reporting and tax implications?
    - Are you aware of what the projected benefit will be for the participant(s) at retirement or the end of the retention period, in addition to what is being funded along the way? Are you aware of the total projected benefit including all employer-sponsored contributions? Is the executive aware of what to expect? Executive understanding is critical to its use as a retention tool.
    - Are there alternatives available? If so, what are the pros and cons?

About the Author

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.

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