Principles of Executive Compensation

Chapter 5

Balancing tips for walking the health care incentives tightrope

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The design of effective compensation programs at health systems must reflect their nonprofit status — the case for the majority of U.S. health systems — while providing sufficient incentive to drive both organizational and individual performance and adherence to their missions. This is particularly complex in an increasingly consolidating, regulated industry. This chapter applies the overarching and operating principles of executive compensation (EC) at health systems using the illustrative example of a fictional nonprofit "Mid-Atlantic Health System."[1] The nonprofit health care organization focused closely on the principles of alignment, engagement and accountability to improve a compensation system hampered by excessive discretion, poor linkage of individual performance to organizational strategy and insufficient depth of eligibility.

In 2015, Mid-Atlantic Health System,[1] a nonprofit health care organization affiliated with an academic medical center, was undergoing sweeping changes similar to those of many other U.S. health care players, driven largely by a reduction in government funding and regulatory shifts associated with the Affordable Care Act (ACA). For example, Mid-Atlantic Health was acquiring several hospitals and a smaller health system, seeking consolidation-related benefits including improved synergies and efficiency.

In this context, Mid-Atlantic Health chose to revisit its incentive plans. Specifically, the organization had suffered from historically inconsistent application of its management incentive plan (MIP). Eligibility for the MIP was determined by the chief executive officer and executive director, who considered how managers' decisions and actions affected the operations of the organization. Without clear guidelines or transparency in the system, the most vocal team leaders tended to have more of their direct reports in the bonus pool.

Management sought to develop and implement more structured, consistent, transparent criteria for determining eligibility for the MIP. Doing so would not only reduce internal tensions and inconsistency but also smooth the way to communicate/articulate the employee value proposition (EVP) for this level of employee. At the time, the number of employees eligible for Mid-Atlantic Health's MIP was less than the market, and it wished to expand eligibility in a sustainable way that reflected the likely reduced future compensation in line with ACA regulatory changes, which were moving health systems from fee-for-service to fee-for-quality.

[1] Mid-Atlantic Health System is a fictional U.S. health care entity. Chapter details are based on our work with established nonprofit health systems.

Thus the new incentive system was expected to enhance *engagement* of executives and other managers and align them with Mid-Atlantic Health's strategic objectives, while also promoting greater *accountability* among top management and attracting well-qualified executives to join the organization. How Mid-Atlantic Health addressed this challenge illustrates how health systems can resolve incentive issues by using a principles-based approach.

What makes health systems distinct?

When thinking about incentives and compensation systems in the health care provider industry, it's important to remember several of their distinct features:

- *Nonprofit:* U.S. health systems are largely nonprofit organizations, operated either as part of academic medical centers (like Mid-Atlantic Health) or as stand-alone nonprofits. That means bonus compensation will generally be more limited than at for-profit companies, including a less leveraged compensation program, or smaller incentives overall and no equity or long-term incentives.
- *Mission is critical:* Many of those who work in health systems are motivated as much or more by the mission of improving community health outcomes than by monetary compensation. At the same time, health systems need to maintain sufficient hiring-related competitiveness with for-profit peers and companies in other industries, especially for staff functions such as human resources (HR) and information technology (IT).
- *Financial constraints due to regulatory matters:* The fast-shifting regulatory landscape for health systems generally means greater restrictions and lower revenues and profits. For example, compensation practices are more likely to be scrutinized by the government as part of overall measures to ensure the organization can maintain its nonprofit status. In this context, organizations need to be strategic about how to ensure incentive programs remain competitive on dimensions including bonus size and eligibility, while also maintaining long-term sustainability.

The next sections discuss the use of the overarching and operating principles to improve Mid-Atlantic Health's compensation system.

Mid-Atlantic Health promotes engagement and accountability with its incentive plan

Mid-Atlantic Health recognized the current compensation system had two issues that needed to be addressed. First, eligibility for bonus was inconsistent and overly discretionary. That meant the executive director faced too much arm-twisting and too many political challenges as managers tried to ensure that they and their people were included in the MIP. This led to different compensation outcomes, even for people in the same job and at the same grade, with similar overall performance. Second, eligibility did not go deep enough in the organization. Consequently, there were recruiting challenges for potential employees and poor engagement and accountability for existing employees, as compensation was only loosely connected to performance, and bonus eligibility unavailable to many at Mid-Atlantic Health. The team started with a review of eligibility criteria, but ultimately revisited

every element of the bonus plan, in part to ensure a stronger, more motivating compensation system for the newly expanded organization.

As a starting point, eight executives were interviewed about what concerns they had about the MIP and what changes they saw as necessary. The themes that emerged from these conversations included the ones mentioned above and others. For instance, inconsistent application of incentive plans not only challenged current managers' engagement but was also a barrier to successful recruitment, as hiring managers were unable to guarantee any bonus eligibility for new hires. Many of these new hires were already reluctant to relocate from larger cities to the smaller city where Mid-Atlantic Health was located. There was also widespread confusion about the organization's compensation philosophy, as most executives knew Mid-Atlantic Health aimed for salaries at the market median but were not sure how total compensation worked. For example, was it based on local market or national market rates? Was it based on health care figures only, even for positions such as those in finance that were not health care related? More MIP transparency and consistency were wanted to understand eligibility, compensation rates and their bases.

An additional challenge was how ACA changed health care providers' compensation from mostly *quantity* of services delivered to service *quality*. So Mid-Atlantic Health's bonus plan expansion had to also recognize the changing health care environment, including greater scrutiny of nonprofit hospital practices (e.g., the perception that excessive compensation was counter to nonprofit status) and a changing marketplace for talent.

At the time of the incentive system review, all managers eligible for bonus had the same performance weightings, with 75% of bonus compensation based on individual performance and 25% on organizational. It was suggested that Mid-Atlantic Health make the individual component larger for managers lower down in the organization, but executives decided to focus first on improving eligibility, recognizing the high level of inconsistency and confusion around this aspect of compensation. They realized the lack of rigor in the system diminished accountability and engagement, and they discussed addressing this by setting smarter goals for individual performance. Moreover, they recognized the low weighting of organizational performance (25% for all executives/managers) led to poor alignment with Mid-Atlantic Health's strategic imperatives and sought to take steps to improve alignment.

To address these issues, the team used an organizational document called "Enhance Mid-Atlantic Health" to connect individual performance goals more closely to strategic imperatives laid out by that document (described below). This would boost alignment by bringing individual and organizational goals into greater congruence. For example, managers had to explain how their people's individual goals (weighted 75%) related to the strategic imperatives. Moreover, the team insisted on setting SMART goals — those that are specific, measurable, attainable, realistic and time-related — at the individual level, to enhance engagement and accountability.

The organization then developed a specific document that managers could use with their teams when setting individual performance criteria for bonus eligibility to tie performance metrics more closely to the strategic plan. The criteria and goals were based on the five strategic imperatives in the "Enhance" document: quality and value, invest in people, patient experience, innovative research and differentiation. For each, the manager and employee developed relevant goals and discussed

eligibility levels: threshold (80% chance of achievement), target (50% chance) and maximum performance (20% chance). These tactics helped tie bonus compensation criteria more closely to organizational strategy and made them more consistent at a given job level, while improving the system's transparency and ultimately enhancing alignment, engagement and accountability.

To ensure competitive compensation levels, Mid-Atlantic Health performed a market assessment to benchmark 18 positions covering about 70 people. They examined absolute compensation levels relative to the health care provider market, along with the proportion of employees at a given level eligible for participation in the bonus plan and how deep into the organization eligibility went. Based on the results, the team revised target bonus opportunities as a percentage of salary and moved eligibility further down in the organization — to the director level for full participation, along with senior managers who had "strategic impact."

The organization also performed a cost-impact analysis, modeling out the costs of including everyone at a certain grade as bonus-eligible to understand how best to roll out the changes and confirm affordability. The results helped them take an incremental approach, with annual inclusion of new pay grades in the plan for the period from 2016 to 2018. This enabled better control over costs through a gradual rather than overnight increase in eligibility.

The team then decided that pay grades that would become eligible for the bonus plan in 2017 and 2018 would be eligible for bonuses up to 5% of their salary rather than 10%, as was the case for those previously eligible or added in 2016, creating a more differentiated, two-tiered bonus structure. To improve consistency, the organization recommended that *anyone* in a given pay grade would be eligible for the bonus plan once that grade became eligible, regardless of specific titles (a given pay grade could include different titles, increasing confusion around the compensation plan).

For senior executives, Mid-Atlantic Health expected to maintain a minimum level of organizational-level financial performance (or a "circuit-breaker") before funding incentives. In line with this, the organization had implemented a circuit-breaker of 90% of budgeted operating margin before any MIP award could be paid to anyone at any organizational level. It was decided to maintain the circuit-breaker at this level to help promote engagement and accountability at the organization's top level in a consistent manner and to prevent an award payout when it would not be consistent with economic stewardship.

Once agreed upon, the new incentive system was communicated widely in the organization. Collectively, the changes more closely aligned Mid-Atlantic Health's MIP with its strategy and moved the organization closer to market on key compensation-plan dimensions, while improving engagement and accountability and likely enhancing future prospects for recruitment and retention.

Mid-Atlantic Health and the operating principles

As suggested earlier, Mid-Atlantic Health used the overarching principles of engagement and accountability to enhance its incentive system's impact for all levels of the organization, while also

focusing on alignment. Below we discuss the most relevant operating principles that supported compensation-related decision making, as grouped by their section within the full set of principles.

Section I: Governing objective and EC philosophy

Operating Principle 2: To ensure the effectiveness of EC programs, organizations must consider the alignment of pay and performance [Alignment].

Mid-Atlantic Health conducted an extensive review of its established compensation system. This included eligibility, connection between organizational goals and individual performance, target levels, comparison of plan elements to the external market, and clear communication of the performance metrics and how these tied back to the high-level strategy. The resultant holistic changes led to an improved incentive system that boosted alignment, engagement and accountability.

Operating Principle 4: EC programs should also be aligned with the organization's culture and relevant individual employee characteristics and, when possible, consider stakeholder preferences. [Purpose, Alignment]

Mid-Atlantic Health connected compensation system features to the organization's strategic imperatives — which also drove its culture — while also taking into account individual contributions as measured by metrics based on those imperatives. To accommodate stakeholder preference, the team implemented graduated changes in the system over a period of three years, such as making new pay grades eligible for bonus on an annual rather than more time-sensitive basis. The culture of caution was also reflected in the preservation of the performance weightings at 75% individual and 25% organizational, not only to maintain a manageable rate of change but also to sustain sufficient managerial resources to address the new acquisitions/integration and adherence to ongoing ACA provisions.

Operating Principle 5: EC decisions should be informed by — but not driven by — market practices. [Engagement]

Mid-Atlantic Health revised its incentive plan to be more competitive with the local market by benchmarking a large number of pay grades to market practices related to absolute compensation levels and depth/proportion of eligibility, communicating these changes to employees for great transparency and engagement.

Section III: Performance-based pay

Operating Principle 6: Organizations should include multiple measures across their incentive plans to promote a comprehensive view of organization performance. [Alignment]

Mid-Atlantic Health used the "Enhance" document to guide development of incentive-related measures and metrics across the board, as tied to the five strategic imperatives, which supported the organization's overall mission as a nonprofit health care provider. While organizational performance

was already weighted 25% in the bonus plan, the changes enabled the 75% individual weighting to be tied more closely to the strategic imperatives, linking individual performance more closely to the overarching, holistic strategic plan.

Operating Principle 11: For senior executives, a reasonable minimum level of organization-level financial performance (i.e., circuit-breaker) must be achieved before incentives can be funded [Accountability].

The health system included a circuit-breaker in its MIP terms for executives, such that 90% of operating margin target had to be achieved for payout, for everyone in the plan. This circuit-breaker promoted both affordability and accountability, while setting a fairly low bar for threshold performance.

Key takeaways

Here are the most important takeaways related to designing or improving incentive systems for health system players:

- *Consistency is critical:* It's essential to ensure that senior leaders are subject to a framework when determining who is eligible for the bonus plan, to avoid awarding incentive compensation to members of teams with the "loudest" voices or the most political power in a primarily discretionary system. A transparent incentive system with clear performance criteria goes a long way toward this objective in a health system.
- *Aim for engagement and sustainability:* The bonus plans of health systems need to perform dual duty by keeping people engaged and accountable while remaining sustainable in the long run, including any effects from regulatory shifts. A strategic approach will help drive a system that covers all these bases effectively.
- *Attend to a changing external landscape:* Strategic or regulatory shifts — such as consolidation and the ACA — represent opportunities for health systems to revisit their strategies and develop incentive programs to drive long-term performance.
- *Tie individual goals to corporate strategy and values:* Individual performance metrics should reflect corporate strategic imperatives and values. Documenting performance expectations in line with stated or implicit strategy and culture goes a long way to enhancing alignment between these critical elements.

Pitfalls of designing compensation systems in health systems

Here are several pitfalls related to incentive plans in health systems:

- *Leaving out communication:* In some cases, organizations spend significant time and effort developing or revamping their compensation systems, only to fail to communicate the changes to their people. Effective communication ensures that participants understand what is changing and

increases transparency, which in turn can enhance employee buy-in and performance. This is particularly important for health systems, which may take a more casual approach to communication because people are generally engaged by the organization's overarching purpose.

- *Engaging people only in the end stage:* It's important to gain input and buy-in from people at *all* levels throughout the process of improving the incentive system. That deeper level of engagement yields richer inputs and greater commitment and ownership across all levels.

- *Failing to make pay systems defensible:* As nonprofit organizations, health systems may come under more scrutiny from the IRS or other government organizations. The pay levels stipulated by an incentive system have to be reasonable, in line with market rates and consistent with the organization's tax-exempt status.

- *Not enough rigor or thought around goal setting:* A well-designed plan can fall flat if the goals at threshold, target and maximum performance levels are not thoughtfully determined. Incentive plan goals should consider multiple inputs, such as the external landscape, historical performance, annual budget, strategic plan, peer performance and probability of achievement, and be adequately rigorous while motivating employees to execute on the organization's strategy and mission.

Things to remember

- The design of effective executive compensation programs at health systems must take into account several factors including such organizations' nonprofit status (resulting in financial restrictions) and ongoing high levels of industry consolidation and regulation. Many health systems' incentive systems are marked by excessive discretion and poor linkage of individual performance to organizational strategy.

- While health system employees are often motivated by the organization's mission, leaders need to design incentive systems that support hiring-related competitiveness with for-profit peers and other sectors, especially for staff functions.

- Following overarching principles of alignment, engagement and accountability can be especially helpful in health system compensation structures. Incentive systems should reflect the organization's strategic imperatives and distinct cultural features, and be informed — but not dictated — by market practices.

- Pitfalls in working with health system compensation include failing to communicate changes organization-wide and neglecting to make the incentive system defensible in the face of government scrutiny.

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