

Linking Incentives to Risk

As health care transforms, boards are tying executive compensation to long-term performance

By Steven T. Sullivan

Many hospital and health system boards and their leadership teams are at an interesting juncture where each is heavily reliant on the other for strategic support and execution. They have a shared goal of successfully moving their organizations forward at a time when the field is in an overwhelming state of transition.

Boards are expecting their leadership teams to establish accountable care organizations by initiating strategic alliances with a wide variety of partners and by re-engineering medical service delivery across the continuum of patient care.

Health care executives, in turn, are asking their boards to support the initiatives needed to expand the delivery of care services. Boards can do this by approving requested capital expenditures, investing in new facilities, hiring clinical and infrastructure personnel, funding risk-managed insurance programs, and purchasing needed technologies for merging and analyzing insurer and provider disease-treatment data.

The unprecedented nature and cost of these initiatives, coupled with a

lack of historical and predictive data, represent an enterprise risk that may be both short- and long-term.

The compensation question

Traditional health care executive compensation programs typically involved short-term bonus opportuni-

ties earned over periods of 12 months or less, and participants' awards were often influenced by performance at multiple organizational levels. In contrast, many experts believe that the fundamental shift in patient care required to succeed in the evolving health care environment will require five to 10 years or more.

The transition will not just be long. It will also be financially challenging, due to diminishing reimbursement rates for traditional hospital-based care. It is clear that success will require the sustained collaborative ef-

forts of increasingly diverse leadership teams working together across traditional and new business units to achieve organizational goals.

"Old school" annual milestones and associated incentive awards will not be sufficient to drive successful transformation. Forward-thinking boards are extending the performance periods in their executives' incentive compensation arrangements in order to align with longer-range indicators of success based on organizational — rather than business unit or departmental — performance. A clearly observable trend is emerging in health care executive compensation: the growing use of long-term incentive plans.

Recent research indicates a growing number of health care systems and independent hospitals now have long-term incentive plans, with more than 40 percent of systems and 20 percent of independent hospitals using them.

Short-term incentive plans tend to focus on financial, clinical quality and patient service performance, which are important to ensure the

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continued viability of an organization. Additional short-term goals, which may focus on areas such as physician satisfaction or patient access to care, should be selected to align with longer-range indicators of organizational success and stakeholder value.

The specific metrics that comprise a carefully designed long-term incentive plan should reflect the board's vision for the organization's future state and provide the leadership team with an opportunity to put the right pieces in place to gradually make that vision a reality. Boards seeking to establish metrics for long-term incentive plans must look to



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future indicators of enterprise value, much as public companies seek a higher future share price for their stock.

Depending on a health care organization's type and the market it's in, its future success may be linked to the growing volume and quality of ambulatory services and preventive care, as well as a reduced reliance on acute care. This transformation will require considerable changes to the structure of health care organizations, the groups they partner with, and the management and sharing of patient care risk.

Reducing risk

At least two layers of potential risk are at play.

Commitment to the array of capital investments needed to fuel transformation may create considerable risk for the organization and the board. At the same time, any accurate assessment of executive team performance requires a multiyear sample of business results; it's hard to pay performance incentives until these are available.

Long-term incentives allow the board to address both factors: It is able to reduce the risk of paying awards before the organization fully implements strategic priorities successfully and before it begins to re-

alize the financial gains associated with them.

An additional strength of using multiyear incentive arrangements is their effect on organizational leadership stability. Strong executive team performance year-over-year creates accumulating value in a long-term plan, which can support executive retention and help the board engage the organization's next generation of leaders.

For example, a \$900 million county health care authority provider's board recently directed the organization to focus on increasing ambulatory care and reducing the rate of inpatient admissions and emergency department care for patients who could have been treated in ambulatory settings. To properly execute the initiative, supporting infrastructure and staffing needed to be established over several years.

Corresponding to this effort, the board compensation committee approved an executive long-term incentive plan that granted annual performance bonus "units" that would vest at the end of three years. The value of these units is driven by the organization's success at reaching specific care delivery and financial goals, a little at a time.

In another example, in an effort to transform care delivery, an indepen-

dent, nonprofit hospital's board decided to implement a number of risk-shared-savings insurance products to control costs by more narrowly defining care, attracting patients and being the first in its market to cover uninsured patients. The hospital now has a long-term incentive program in place that can grow in value as the organization enrolls more patients in the insurance plans and delivers strong financial performance over multiple years.

In both examples, use of long-term incentives drives executive teams to successfully enact broad strategic changes, while the organization forgoes incentive payout until those changes deliver improved financial performance and demonstrate long-term transformation. The risk of paying executive incentive awards when necessary milestones are not achieved is reduced.

Use of long-term incentives is likely to accelerate as more health care organization trustees understand how such compensation can drive change and mitigate risk while avoiding the opportunity costs associated with lagging transformation. **T**

Steven T. Sullivan (*steven.sullivan@pearlmeyer.com*) is a principal at Pearl Meyer, a New York City-based executive compensation consulting firm.

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