BDO

2019/2020 INSIGHTS REPORT

Key Insights Regarding Executive Compensation in the Health Insurance Industry

EXECUTIVE SUMMARY

The recently published *BDO Health Insurance Industry Executive & Management Total Potential Remuneration (TPR) Survey* is a rich source of information about executive compensation relied upon by boards and management.

The BDO survey reveals insights to key questions related to compensation and performance measures that help health insurers focus on the right executive compensation strategies that yield desired results. This summary Insights Report details a few of the findings from the full report, which addresses a variety of issues, including:

- Do companies need to restructure pay and delivery to retain their top team?
- Will performance metrics need to be adjusted, without lowering the bar, to more accurately account for real growth and performance?
- How much of an executive's pay should be at risk (i.e., variable pay that is only earned if specific performance metrics are achieved)?
  - Is the mix of at-risk pay properly balanced with a clear line of sight to the business objectives?
- How much pay should be allocated to Supplemental Executive Retirement Plans (SERPs) and Change of Control agreements (COCs)?

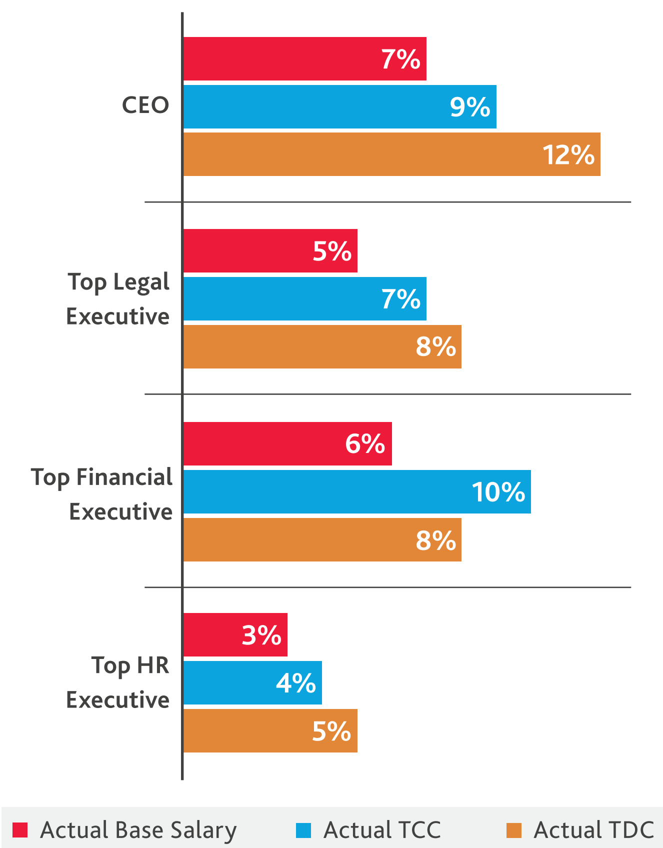
Health insurance companies are seeking new and better ways to retain talent and incentivize executives to increase profits and improve their financial stability. Profitably is under pressure due to rising healthcare costs, growing competition, the drive for operational efficiencies, and new legislation that includes mandating minimum medical loss ratios. Companies evaluating opportunities to reward their top executives should consider the following four trends to guide their executive compensation planning:

- CEO pay outpaces growth of revenue and pay for other top executives.
- Growth in premiums and other incentive plan financial metrics outpace membership enrollment.
- Variable pay continues to gain prominence for health insurance executives.
- SERPS and COC agreements are common, but carry potential risks.

1. CEO PAY OUTPACES GROWTH OF REVENUE AND PAY FOR OTHER TOP EXECUTIVES.

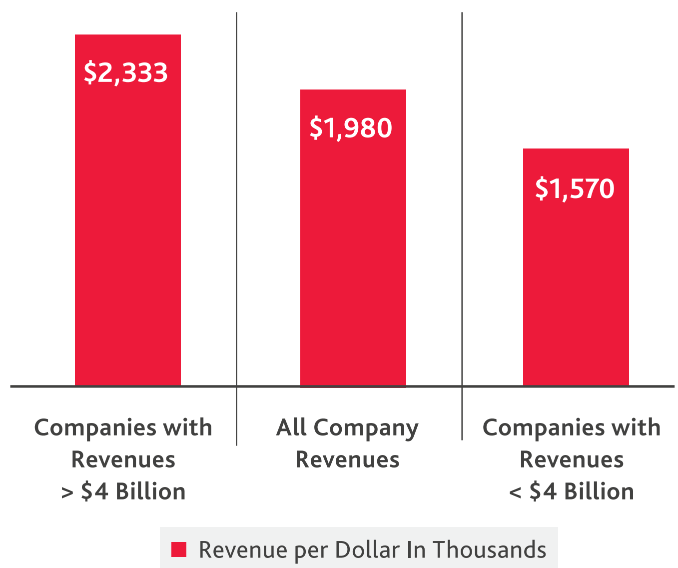
On average, total direct compensation[1] for the Chief Executive Officer (CEO) increased 12% year-over-year – higher than the 6% increase in total revenue[2] for these companies. Growth in CEO total direct compensation is also outpacing that of other top executives, as much as 1.5 to 2.4 times faster (see figure 1). Salaries for the CEO and most other top executives are increasing faster than the typical merit increase, which hovers around 3%.

FIGURE 1
AVERAGE CHANGE IN ACTUAL PAY FROM 2018-2019[3]



Executive pay levels typically increase alongside company size. For instance, the median salary for CEOs in companies with revenues greater than $4 billion is about 20% higher than the median salary for CEOs at companies with revenues of less than $4 billion. However, that does not necessarily mean that larger companies overpay their CEO. We compared pay levels relative to revenues and found that larger-sized companies seem more efficient with regard to the revenue earned per dollar of CEO pay (see figure 2).

FIGURE 2
REVENUE PER DOLLAR OF CEO COMPENSATION – AVERAGE



CEO compensation levels reflect the challenging environment companies face in retaining their top-tier team:

- Boards and other stakeholders typically feel that to be a leader in an industry, the company must have the top CEO at the helm. The CEO role is very difficult, and the pool of qualified candidates is small.
- A solid economy and rising healthcare costs have bolstered health insurance companies' sales/revenues and corporate tax cuts have improved net income. *Both of these performance metrics are prevalent in the incentive pay structures by which CEOs are held accountable.*

1 Sum of base salary plus annual incentives and long-term incentives (LTI).
2 2018 and 2019 Health Insurance Industry Executive & Management Total Potential Remuneration Survey editions.
3 Analysis is based on the companies matching the job in both the 2018 and 2019 survey editions.

2. GROWTH IN PREMIUMS AND OTHER INCENTIVE PLAN FINANCIAL METRICS OUTPACE MEMBERSHIP ENROLLMENT.

Choosing the right metrics for an incentive plan is key to ensuring that executives are rewarded for achieving goals that drive the success of the company. Our survey identified some of the most commonly utilized metrics in annual and long-term incentive plans for health insurance executives:

- Contract/Member Growth (82%)
- Customer Satisfaction (76%)
- Net Income/Profit (65%)
- Revenue Growth (35%)

One might expect that membership growth, revenue, and profitability would track closely. However, BDO found that net income and net premiums written increased at a five-year compounded average growth rate (CAGR) of 16% and 5%, respectively, whereas total health enrollment only increased at a 3% CAGR[4].

This comparison of performance metrics to actual results illustrates that increases in revenue and profits do not necessarily reflect true organic growth. It further prompts the question as to which metrics should be used in an incentive plan and how they should be weighted. While growth may impact revenue and profits, there are additional factors to consider (see figure 3).

FIGURE 3
EFFECTIVENESS OF METRICS USED IN INCENTIVE PLANS

INDICATOR OF GROWTH

MODERATE	BETTER	BEST
Revenue Growth Can be influenced by price increases	**Net Income/Profit** Can be influenced by operating costs, revenues, expenses	**Membership/Enrollment/Market Share** Signifies new membership

True organic growth/business expansion can be measured best by membership and market share.

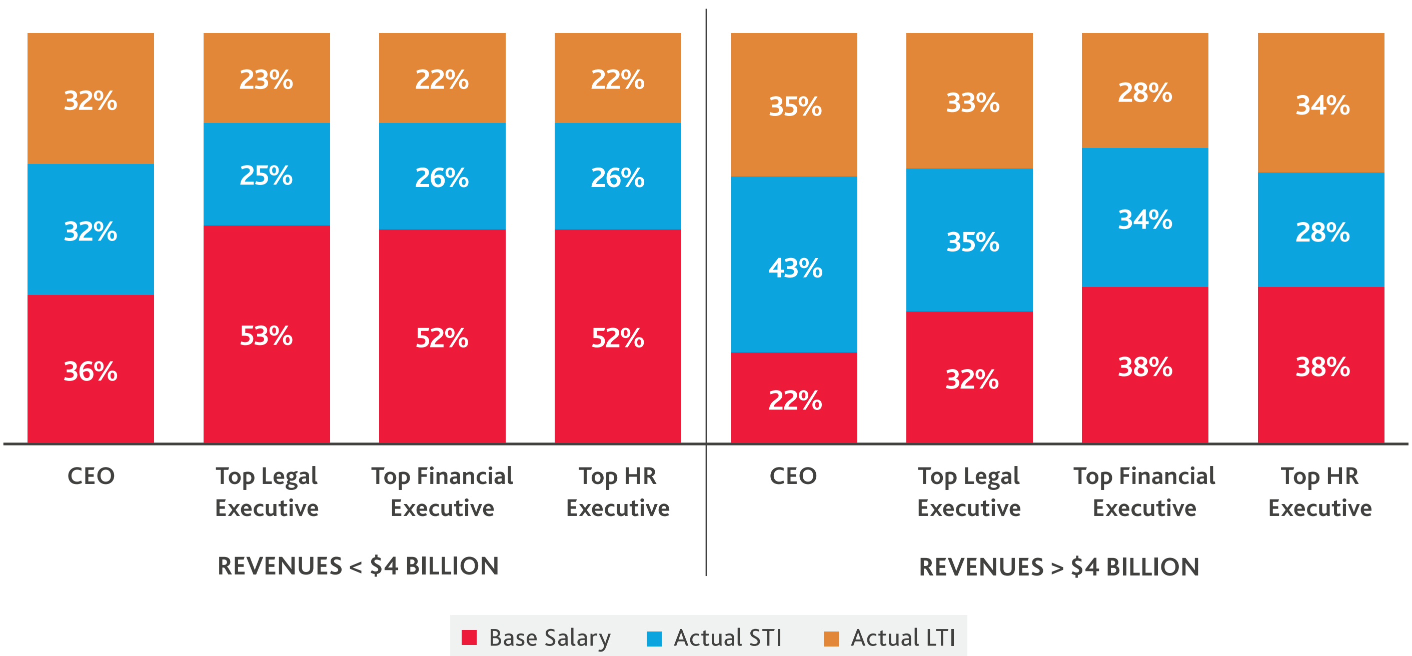
4 Source of company financials: S&P Market Insight.

3. VARIABLE PAY CONTINUES TO GAIN PROMINENCE FOR HEALTH INSURANCE EXECUTIVES.

Variable pay for health insurance executives is growing in terms of usage and target incentive opportunity.[5] In fact, the 2019 TPR Survey results showed that all but one company reported having an annual incentive plan; and all but two companies reported having a long-term incentive plan.

Pay is more leveraged for executives of larger companies, as illustrated in Figure 4. This is partially driven by LTI, which represents a larger percentage of pay for the bigger players.

FIGURE 4
2019 AVERAGE MIX OF PAY BY REVENUE SIZE



Other insights related to incentive plans include:

- The annual incentive target opportunity for top executives increased, on average, by 3 percentage points over the prior year's results.
- Long-term incentive plan eligibility extends to CEOs, their direct reports, and other executives. In addition, other key officers are eligible to participate in a long-term incentive plan to a lesser degree.
- Long-term cash bonuses are the most widely used incentive plan award for the health insurance companies participating in our survey (a majority are not publicly traded).

5 "Target Incentive Opportunity" is the amount of annual or long-term incentive earned if performance expectations are met.

4. SERPS AND COC AGREEMENTS ARE COMMON, BUT CARRY POTENTIAL RISKS

In addition to cash compensation, executives may be eligible for Supplemental Executive Retirement Plans (SERPs) or Change of Control (COC) agreements:

- SERPs provide benefits above and beyond those covered in other retirement plans.
- COC agreements may provide a severance, bonus payments, or accelerated vesting of equity awards. They are designed to incentivize executives to remain with the company upon a change in control/acquisition by another company.

These plans are very common, offered by 67% of health insurance companies. They serve as important executive retention devices. Unfortunately, upon a triggering event[6] (two-thirds of surveyed companies require a double trigger), the size of the payouts can be newsworthy. Boards, management, and other stakeholders are advised to be cognizant of the size of these potential payouts and ensure that the amounts are defensible.

For instance, the potential annual annuity of retirement benefits, including SERPs, is 87% of the CEO's salary level (see figure 5).

FIGURE 5
POTENTIAL ANNUALIZED VALUE OF SERPS EXPRESSED AS A PERCENTAGE OF CURRENT BASE SALARY[7]

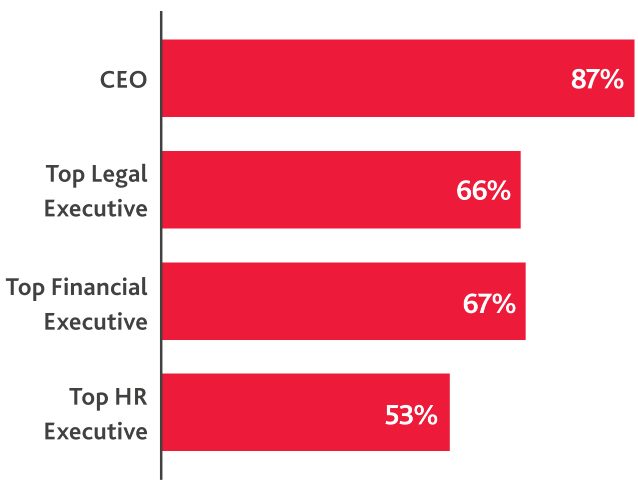
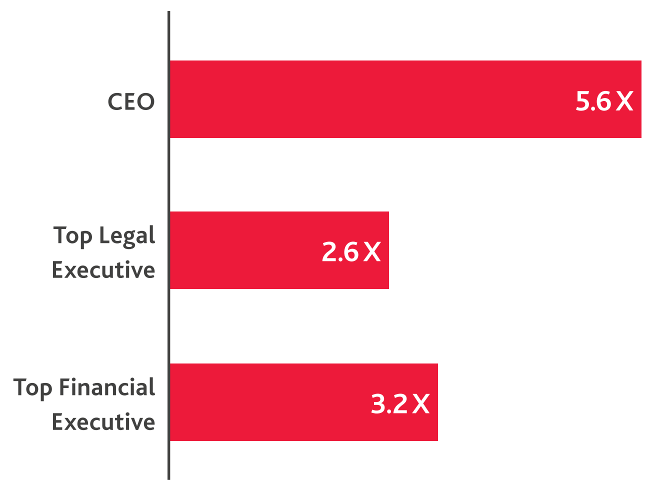


FIGURE 6
POTENTIAL CHANGE OF CONTROL PAYOUT EXPRESSED AS A MULTIPLE OF CURRENT BASE SALARY[8]



The potential payout for a change of control agreement is over five times the CEO's salary level – which can translate to a payout of several million dollars. While the payouts for other executives are lower, they are still significant (see figure 6).

Compensation is a critical tool for attracting and retaining executives as well as driving the right strategy. It is important to know what other companies are doing; however, it is also important to ensure your program (1) aligns with your company's market, mission, and strategy and (2) is sized correctly to balance the needs of all stakeholders.

6 Examples of a "triggering event" include the sale or merger of the company, or termination of the executive without cause.

7 2019 Health Insurance Industry Executive & Management Total Potential Remuneration Survey.

8 Insufficient data to display Top HR Executive.

ABOUT OUR SURVEY

The annual *Executive Total Potential Remuneration Compensation, Benefits, and Perquisites Survey* (TPR Survey) provides data on compensation, benefits, perquisites, and contract agreements for executive and senior management positions in health insurance organizations. Data analysis falls into three categories:

- Compensation levels
- Total Potential Remuneration levels
- Policies and practices

SURVEY OVERVIEW

- Most recent publication date: August 2018
- Number of annual survey respondents: 16 to 23 health insurance organizations annually
- Number of positions included: 44 executive- and director-level positions, including hot job titles such as chief data analytics officer, head of retail market development & consumerism, and top healthcare informatics executive
- Pay elements included:
    - Base pay
    - Target, minimum, and maximum AI levels
    - Actual AI payout amounts
    - LTI grants (annualized value)
- Benefit and perquisite levels are quantified and included:
    - Executive benefits and perquisites
    - Deferred compensation and pensions (qualified and nonqualified)
    - Potential value of COC and severance agreements
- Policies and practices:
    - AI plan design
    - LTI plan design
    - Retirement benefits, including SERPs
    - Deferred compensation
    - Perquisites
    - Employment, COC, and severance agreements

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Our services are tailored and scalable, designed to accommodate the unique needs of public, private, and nonprofit clients of all sizes and across all industries including multinational Fortune 500 companies.

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Learn more about BDO's Compensation Surveys practice.

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