ADAPTATION FUND

AFB/PPRC.31/64
14 March 2023

4Adaptation Fund Board
Project and Programme Review Committee
Fortieth Meeting
Bonn, Germany

Agenda Item 22

INNOVATION PROJECT DESIGN ELEMENTS AND FURTHER CLARIFICATION ON THE CONCEPT OF RISK

Background

1. At the thirty-ninth meeting of the Adaptation Fund Board (the Board), the secretariat presented document AFB/B.39/10 "Further analysis of elements related to innovation: mapping finance for innovation, risk appetite, and options for the Innovation Body." Following this, the Board decided:

(a) To request the secretariat to develop a draft risk framework for innovation projects and programmes, along with desired risk-tolerance targets for the Adaptation Fund's innovation projects portfolio, taking into account the differences among the innovation funding windows;

(b) To request the secretariat to, in conjunction with subparagraph (a) above, indicate and clarify the project design elements that are encouraged in innovation, elaborating on the concept of acceptable or desirable risk, with a view to providing guidance to implementing entities;

(c) To request the secretariat, in consultation with the Innovation Task Force, to further develop principles for the advisory body for innovation referred to in document AFB/B.39/10, including a draft terms of reference, taking into account the developments with the Medium-Term Strategy 2023–2027;

(d) To request the secretariat to present its analyses and recommendations related to subparagraphs (a) to (c) above to the Project and Programme Review Committee at its thirty-first meeting.

(Decision B.39/65)

2. In accordance with sub-paragraphs (a) and (b) of Decision B.39/65 above, the secretariat has prepared the present document for the consideration of the Project and Programme Review Committee (PPRC).

Draft Risk Framework

3. The Board at the second session of the thirty-fifth meeting considered the document AFB/PPRC.26.b/17 which defined "risk appetite" as the amount of risk an organization is willing to accept in pursuit of its strategic objectives. As stated in document AFB/B.39/10, the Fund applies a general risk management framework, approved at the twenty-fourth meeting of the Board (Decision B.24/24), for which there are well-established policies and procedures for assessing various risks namely through its Environmental and Social Policy, and Gender Policy. Further, all project and programme proposals must describe risk assessment and management plans relating to project-level risks.

4. As described in document AFB/B.39/10 the different classes of risk can be distinguished as follows:

a. Non-project-specific risks: country risks (including political and security risks), macro-economic risks, currency risk, natural/man-made disasters, etc. These are the risks that cannot be prevented by the Fund, and therefore their management will depend on identification and elaboration of mitigation measures (for example, policies developed by the Fund during COVID-19 to ensure continuity of project-related processes).

b. Project-specific risks: operational and management risks, governance risks, and environmental and social risks. The Fund has in place processes for identifying them and policies (for example, the Environmental and Social Policy) for avoiding or mitigating such risks.

c. Innovation-specific risk: these are risks that are taken in order to achieve superior returns or outcomes, compared to the "average" or "baseline" scenario.

d. The risk of not taking a risk: this is the risk of not supporting generating and implementing ideas that would lead to superior returns or outcomes. This is also an innovation-specific risk (i.e. failure to innovate). Unlike the previous one, where the main problem may lie in deliberately taking on risk that is too high, this one is about choices that opt for risk that is too low or avoid risk altogether.

5. As non-project- and project-specific risks listed under (a) and (b) above are relevant for all types of Funds' projects, and the Fund's risk management functions pertaining to those types of risk go beyond and include innovation projects, the development of a draft risk framework for innovation project and programmes focuses on primarily (c) and to some extent, at least conceptually, on (d)[1].

6. Some context regarding how these risks function is provided below, illustrated in Figure 1, which shows the possible outcomes that can occur depending on whether or not an adequate level of risk tolerance has been set and whether there is sound risk management.

[1] The two categories of risk are related to each other – effectively, one is "too much" and the other one "too little".

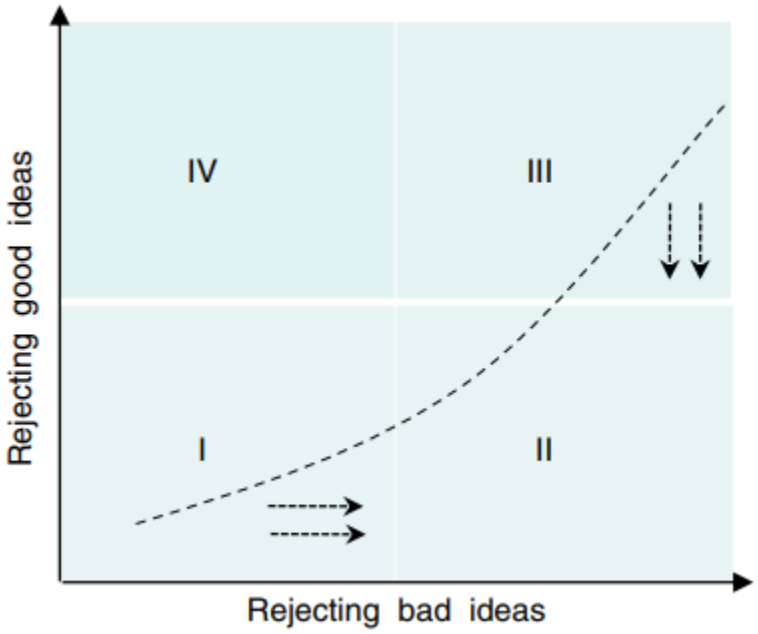

Figure 1. Risks in innovation (*Source: Bowers and Khorkian 2014*[2])

7. For instance, Zone I represents an environment where good ideas (a.k.a. innovation initiatives) are unlikely to be rejected, which is conducive to innovation. However, this is also where bad ideas are unlikely to be rejected, which would lead to losses. Accepting bad ideas is the main risk for (c) above. Likewise, Zone III above illustrates what happens when no risk is taken – neither good nor bad ideas are considered. The failure to consider good ideas represents the main risk under (d) above.

8. Building on previous work, for example Document AFB/B.36.8, it is understood that some uncertainty in the outcomes of an innovation project is expected. An effective risk framework is one that leads to Zone II outcomes – whereby bad ideas or innovation initiatives are rejected and good innovation ideas are considered and retained, and the appropriate level of risk is chosen.

9. Generally speaking, innovation benefits from a system that is conducive to generating ideas or initiatives, containing mechanisms to critically assess them, and the possibility to reject them at any stage, if necessary. The immediate purpose of innovation funding is to help innovation thrive. In the context of the Adaptation Fund, besides implementing innovative projects, this support to innovation can also include bridging the gaps in finance on the way to scalability or financial sustainability, enabling scaling up, lowering the barriers to private sector investment in adaptation and, of course, learning

[2] Bowers, J and Khorkian, A. 2014. *Integrating Risk Management in the Innovation Project.* European Journal of Innovation Management Vol. 17 No. 1, 2014 pp. 25-40 (DOI 10.1108/EJIM-01-2013-0010)

and sharing about innovation. The Medium-term Strategy II (2023-2027) lists the Fund's four Expected Results (ER 1-4) under the Innovation Pillar.

10. As such, the following simple risk framework is put forth to help guide implementing entities of the Fund, based on the ERs, and keeping the key principle stated in the previous paragraph. The risk of not achieving the ERs is described at the scale of a project (i.e. not portfolio) with a view of providing guidance to IEs in considering whether its project design might contain such a risk. In a subsequent section, distinct innovation project design elements are discussed, which could also help manage these risks.

Table 1. Innovation risk management framework

Risk	*Description*	*Potential Diagnostic*	*Potential Mitigation*
New innovations and risk-taking are not encouraged and accelerated	*No new ideas are generated or are generated very slowly.*	*Does the project provide a space or mechanism for ideation, crowd-sourcing and dynamic and creative problem-solving, without prejudice?*	*Co-creation process from the idea stage (18.a)* *Encouraging risk-taking practices in during implementation (18.b)*
Successful innovations are not replicated and scaled up	*Successful innovations are not recognized. There is no process to assess for quality. Pathways for replication and scaling up are not known or accessible.*	*Does the project put processes in place that critically assess the success of innovations? Are there mechanisms in place that can support the replication and scaling up of successful innovations?*	*Capital options in addition to Adaptation Fund financing (18.d)* *Use of Adaptation Fund financing to support financial instruments for risk mitigation (18.e)*
Access and capacities for designing and implementing	*Implementing entities are unable to design projects that support innovation*	*Does the IE have a process or plan in place for building its capacity in innovation project*	*Co-creation process from idea stage (18.a)* *Encouraging risk-taking practices*

innovation are not enhanced	*processes and contain key innovation elements.*	*design? Is the IE able to access support and tools that enable innovation project design?*	*during implementation (18.b)* *KPIs setting process for selected SMEs/ entrepreneurs (18.c)* *Open innovation session during implementation (18.f)*
Evidence base is not generated and not shared	*Poor or weak innovations or ideas are not recognized and categorized as such, and thus may be replicated. Good innovations are not recognized and are not being replicated. Processes to assess innovations do not improve.*	*Does the project capture and assess the knowledge on ideas and innovations? Does the project capture the information gained on the processes, functions and elements of innovation?*	*Systems to generate and use evidence, to allow to accelerate, change course or abandon the initiative (18.g)* *Sharing evidence, e.g. through participation in innovation Knowledge hubs, communities of practice and national/ regional/ global sharing events. (18.g)* *Additional outputs may also mitigate this risk, such as patents, ISO standards and publications (white and gray literature.)*

Risk tolerance targets

11. As per Document AFB/PPRC.26.b/17 and reiterated in Document AFB/B.39/10, regular project modalities and conventional risk appetites can lead to incremental innovation. Intolerance for failure results in conservative goal setting (modest and achievable targets) and risk aversion (reliance on proven, established approaches), which, in turn, is expected to result in strong disincentives to innovate. This means that, in absence of incentives to innovate, there is a strong tendency for both IEs and countries to fall back on tried and tested solutions (with projects that tend towards Zone III in Figure 1).

12. Innovation funding is intended to push the interventions into areas of calculated or strategic risk (i.e. Zone II in Figure 1), but not so far that the level of risk tolerance veers into unproductive territory (Zone I or, worse yet, Zone IV in Figure 1).

13. Document AFB/B.39/10 introduced some general principles in setting risk tolerance targets, namely the idea of differentiated risk targets for different innovation windows, and primarily correlating with the size of the individual innovation grant, such that "higher levels of risk would be acceptable for smaller grants" relative to larger innovation grants.

14. Setting project or portfolio-level target for risk tolerance is a somewhat theoretical and arbitrary exercise. For a new and groundbreaking portfolio, one of the main utilities of target-setting, at least initially, is that it enables benchmarking, and hence, adjustments based on evidence from that portfolio that is yet to be generated. The rate of failure of innovation projects is high but varies considerably depending on which domain is being measured[3]. Still, a successful innovation *portfolio* should be able to demonstrate relatively higher prevalence of instances of outstanding projects in terms of performance, compared to a less risky portfolio, over time. At the same time, achieving a higher rate of outstanding success may mean, at a portfolio level, a commensurate reduction of the proportion of projects that are moderately successful. It may also mean an increase, relative to the less risky portfolio, in the proportion of projects that are unsuccessful.

15. One of the metrics used to characterize the Fund's overall portfolio of projects is the implementation progress rating, which shows overall distribution of portfolio by project rating, which ranges from Unsatisfactory to Highly Satisfactory. Based on ratings of the

[3] "[…]35 per cent of innovation projects fail commercially, accounting for 45 per cent of new product expenditure (Halman and Keizer, 1994). In some industrialised countries the success rate of new products is 15 per cent and among developing countries, such as Hong Kong, it is just 2 per cent (Ozer, 2006)." Cited from: Bowers, J and Khorkian, A. 2014. *Integrating Risk Management in the Innovation Project.* European Journal of Innovation Management Vol. 17 No. 1, 2014 pp. 25-40 (DOI 10.1108/EJIM-01-2013-0010)

project performance reports (PPRs) received from 2011 up to 30 June 2022, 70.5 of the PPRs being rated as satisfactory and above (Figure 2).

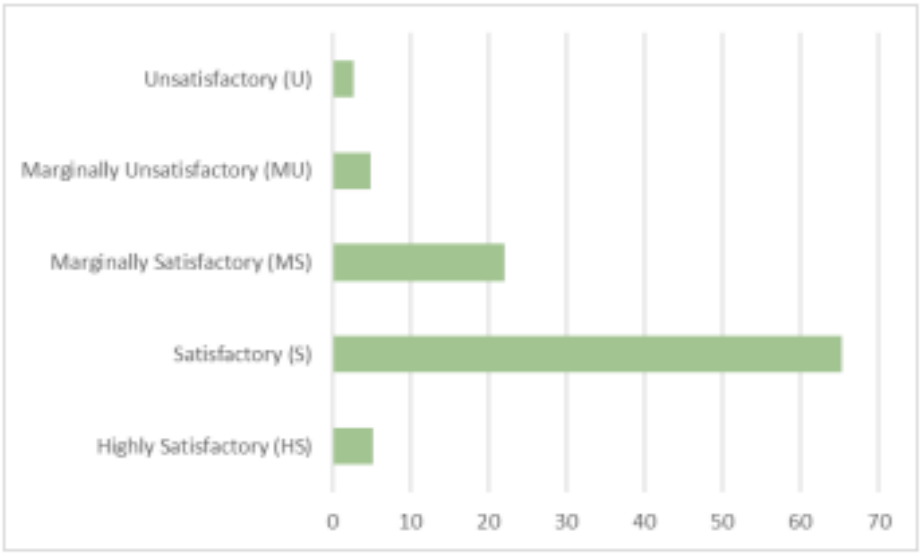

Figure 2. Project implementation progress ratings (percentage of total portfolio)

16. Given the understanding of innovation rates of success, a higher proportion of Unsatisfactory and/or Marginally Unsatisfactory projects, compared to the rest of the overall portfolio of the Fund, could be reasonably expected. However, the proposed risk tolerance target for an innovation portfolio would go hand-in-hand with a ratings target of higher proportion of Highly Satisfactory ratings, compared to the rest of the overall portfolio of the Fund.

17. The proposed targets can be seen in Table 2 below, whereby the target or ambition for Highly Satisfactory ratings is to triple for the Small Grants Innovation portfolio, compared to the Fund's overall portfolio or baseline. At the same time, the tolerance for Unsatisfactory/Marginally Unsatisfactory ratings would triple as well, compared to the baseline. The target and ambition would be more conservative for the Large Innovation Projects.

Table 2. Proposed risk tolerance targets

Rating	*Portfolio baseline (%)*	*Innovation portfolio risk tolerance target (%) – Large Grants*	*Innovation portfolio risk tolerance target (%) – Small Grants*
Unsatisfactory	*3*	*16*	*27*

Marginally Unsatisfactory	*5*		
Marginally Satisfactory	*22*	*74*	*68*
Satisfactory	*65*		
Highly Satisfactory	*5*	*10*	*15*

Innovation project design elements

18. The nature of innovation requires a different approach from that which is normally observed in the mainstream adaptation or similar projects. An innovation project often aims towards radically better results compared to a conventional project, often focusing on identifying one or many solutions to a specific problem implementing, rather than on implementing any pre-identified solution. An innovation project has a heightened linkage with learning, with normally double-loop learning embedded in the project implementation, i.e. adjusting the course of the project frequently and rapidly based on new information gained from the implementation. In addition, thehe following are some of the main recurring elements within innovation projects. They are listed here to serve as provisional components or choices from a menu of options, with a view to be used as a basis for an eventual guidance to the implementing entities.

a. *Co-Creation process from idea stage (small grants):* This generally includes events that aim to collaboratively define the problem and better solutions together with various stakeholders including youth, women, disabled people, researchers, civil society, indigenous people, entrepreneurs, private sector and others, as needed. Hackathons or competition events are some of the examples of such events. These events foster an environment that promotes creativity, collaboration with diverse stakeholders, and public awareness. The involvement of the public, private sector, and other stakeholders plays a crucial role in these events.

Table 3. The role of various stakeholders in innovation events

Actor	*Role*

Public (IEs)	- Concept development (theme, problem statements, application eligibility, etc.) - Providing incentives (e.g., prizes, awards) - Post-event support to selected teams/ executing entities (monitoring, etc.) - Developing and improving concepts and processes for subsequent events
Incubator/Consultant	- Running the event in collaboration with IEs
Private (commercial banks, companies, etc)	- Sponsorship - Serving as a competition panel judge
Participants/potential grantees	- Bringing diverse ideas to the table

b. *Encouraging risk-taking practices in the project process (small grants)*: Innovation is a process of constantly discovering improvements to the conventional way of doing things. It is important to design the project that creates an environment enabling IEs to have the space and freedom to experiment. However, changing the mindset of IEs from traditional practices to a risk-taking culture that embraces learning from failure can be challenging in project design. One solution is to incorporate the number of trial-and-error stories as a critical indicator in the Project Results Framework. *The project should evaluate the number of cycles (test, learn, develop) instead of solely focusing on success or failure. This approach enables stakeholders to accumulate knowledge and discover solutions that meet their needs through the iterative cycle. It is important to ensure that the cycle (test, learn, develop) is fast-paced.*

c. *KPIs Ssetting process for selected SMEs/Entrepreneurs (mainly for large innovation projects and AFCIA)*: Accredited Entities have the flexibility to determine the timing and method of disbursing grants to selected SMEs/entrepreneurs. While it may be counterproductive to strictly adhere to conventional [4] result-based financing, it is important to monitor the progress of SMEs/entrepreneurs. One approach could be to request Accredited Entities to include the process of deciding Key Performance

[4] Where "result" is a proxy for a conventionally successful adaptation intervention, which is not necessarily how an innovation project may unfold.

Indicators (KPIs) concerning impact during their discussion with SMEs/entrepreneurs. This process would also be beneficial for SMEs/entrepreneurs, as well as IEs, for benchmarking purposes. (Demonstrating track records with KPI is also an essential component of investor pitch.)

d. *Capital options in addition to Adaptation Fund financing (scale-up financing):* proposals can be designed to provide awards to selected SMEs/entrepreneurs, with various activities aimed at attracting private investment during the program/project. While grants can be a crucial source of funding and support for SMEs/entrepreneurs looking to scale up their business or move to the next stage, securing investment from investors and financial institutions, particularly in high-risk countries, can be a daunting task. In this regard, public sector can play a vital role in providing catalytic capital.

e. *Use of Adaptation Fund financing for innovative risk instruments:* Securing capital for innovation in adaptation to climate change is not yet an established practice. IEs and other grantees may face challenges in securing loans, guarantees and subsidies to finance their innovative adaptation initiative. The Fund could potentially consider funding initiatives that can support SMEs/entrepreneurs who have investors but need co-financing for risk mitigation.

f. *Open innovation session during the SMEs/entrepreneurs' implementation (small and large innovation projects, and AFCIA):* The objective of this session is to empower SMEs/entrepreneurs by leveraging external information and resources. To proactively drive innovation rather than waiting for the results of their activities, it is crucial to integrate such sessions into the implementation phase. This approach allows SMEs/entrepreneurs to adapt their original ideas or business models as needed, while simultaneously mitigating any negative impact on the community. Additionally, various stakeholders, including NIEs, can monitor the progress/journey of the SMEs/entrepreneurs as they develop tailored solutions that meet specific needs.

g. *Generate and integrate evidence and knowledge sharing (small, large AFCIA):* Project and programmes should set up a system to generate and use evidence. Generating evidence entails measuring and documenting key features of the project that allows for determining course-corrections and next steps. It includes information that can be used to either justify or deny a hypothesis or claim made by the proposed innovative approach, solution or technology. This process should occur repeatedly throughout the project. ~~Finally,~~ In addition, learning needs to be captured with a view to

sharing with the wider climate adaptation community, and may entail creating sharing opportunities. Some examples for enhancing knowledge sharing are creation of innovation knowledge hubs, communities of practice and national/ regional/ global sharing events.

Recommendation

19. Having considered Document AFB/PPRC.31/64, the PPRC may wish to recommend to the Board:

(a) To adopt the draft risk framework for innovation projects and programmes presented in Document AFB/PPRC.31/64, Table 1, along with the risk-tolerance targets for the Adaptation Fund's innovation projects portfolio in Table 2;

(b) To endorse the project design elements that are encouraged in innovation;

(c) To request the secretariat to develop tools and guidance, for the National Implementing Entities of the Adaptation Fund with a view to supporting project design and faster access to small grant innovation funding on the basis of the project design elements referenced in subparagraph (b) above;

(d) To consider further how Adaptation Fund finance could be used to access funding for innovation, and to report to the Project and Programme Review Committee at its thirty-third meeting.