GUIDELINES

Challenge Funds

A guide based on Sida's and other actors work using Challenge Funds in development assistance/as a method for development.

1. INTRODUCTION

The purpose of this note is to encourage the Swedish embassies and different departments in Sida to understand and consider the use of **challenge funds** (CF) as a method to achieve development results. The note gives examples of different kinds of CFs, provides lessons learned from early and on-going projects, discusses some principles which are essential in setting up and managing such funds and provides practical guidelines for establishing CFs. Even if this note is focusing on challenge funds set up by donors, this could be a financing mechanism for any organization willing to solve a specific problem with innovative solutions. Swedish Embassies/Sida could therefore consider, if suitable, supporting a partner country to set up a challenge fund as an alternative to the Embassy.

1.2. What is a Challenge Fund?

A challenge fund is a financing mechanism to allocate (donor) funds for specific purposes using competition among organizations as the lead principle. A challenge fund invites for proposals from companies, organizations and institutions working in a targeted field to submit project proposals. Challenge funds are always set up to meet specific objectives – such as extending financial services to poor people; finding solutions to a specific health problem in developing countries; as a means of triggering investment to certain high-risk markets; to stimulate innovation for effective use of water resources, etc. The scope of using CF for creative problem-solving in development is very wide.

Proposals are assessed against transparent and pre-determined criteria. Successful applicants must usually match a certain percentage of the grant with own financing. The CF awards grants to those projects that best meet the objectives of the fund and fulfill various pre-established eligibility criteria.

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Challenge funds have been applied by donors since the late 1990s and there are a variety of such funds. The management of challenge funds is usually subcontracted by donors to specialist organizations through a competitive bidding process. Some challenge funds are also used outside development assistance.[1]

1.3. The rationale behind Challenge Funds

Several factors drive the interest in the donor community for challenge funds:

- Development assistance tries to engage more actors than in the past, in particular the business community.
- Competition is increasingly seen as a method of accomplishing development through triggering a search for smart and cost-effective solutions.
- Innovation is moving up the development agenda as a means of solving major societal problems, including poverty and environmental issues. Innovation lends itself to the challenge fund concept.
- Challenge funds provide leverage of donor funds by engaging private capital in matching financing of projects.
- Challenge funds are a mechanism that allows for directly working with commercial players without creating market distortions.
- Challenge funds are different from conventional competitive bidding processes as CFs seek to provide generic results rather than specific; they focus on a desired outcome or result but are not prescribing the means of how such results should be achieved, and they allow several winners.

1.4. Who applies challenge funds in development cooperation?

British DFID was a pioneer in setting up challenge funds for development purposes in the late 1990s. The first efforts included four CFs for business linkages, financial deepening, tourism and civil society. The Consultative Group to Assist the Poorest (CGAP) launched a competitive innovation fund in 2002, the ProPoor Innovation Challenge, providing grants to microfinance organizations for innovative methodologies to deepen rural poverty outreach and impact. Australian aid and Canadian aid followed, and USAid is also increasingly engaged in large scale challenge funds.

Some of the challenge funds are very large, for example Grand Challenge Canada, a CF focusing on innovations in health with a fund of C$ 225 million (SEK 1,5 billion). Others are small, for example a DFID/ADB fund in Vietnam of USD 3 million (SEK 20 million).

Annex 1 provides examples of challenge funds undertaken by UN, DFID, AusAid, USAid, Canadian aid and a less well known organization as the Mohammed bin Rashid Al Maktoum Foundation. These examples are far from exhaustive, but included to show a range of different applications.

2. SIDA´S WORK WITH CHALLENGE FUNDS

Sida has so far established two challenge funds on its own:
1) *Demo Environment* which started as a pilot phase 2007 and is currently operating for 2012-13; and
2) *Innovation Against Poverty* (IAP) which started in 2011 for an initial 3-year period. Since 2012, Sida is also co-financing a large, multi-donor fund, the Africa Enterprise Challenge Fund (AECF). These are described more in detail below.

2.1. Demo Environment started as a pilot project in 2007 covering about 40 countries in a phase ending in 2010. After a review it was somewhat modified and is currently operating for the period 2012-13. The objective of the new Demo Environment is to promote sustainable growth and a stronger business sector in the area of environmental technology that contributes to better living conditions in selected Sida partner countries.Two forms of grants are provided, one for planning purposes (mainly for a company to explore markets) of up to SEK 284,000 and one for demonstration projects with a grant of up to SEK 1,8 million and with a minimum level of SEK 0,5 million. Demo Environment is only open to Swedish Small and Medium Enterprises (SMEs), NGOs and Swedish public entities such as authorities and universities. In terms of the demonstration grants, the potential customer of the environmental technology in any of the target countries must apply. Demo Environment is open in seven countries: Botswana, Namibia, South Africa, India, Indonesia, China and Vietnam. The program has been implemented on behalf of Sida by Tillväxtverket since 2007. Demo Environment has a budget of SEK 48 million for the period 2012-2013[2].

2.2. Innovations Against Poverty was launched in 2011. The program, which took its inspiration from the Base of the Pyramid concept, functions as a risk-sharing mechanism for business ventures (commercial companies or market oriented organizations) which have a strong potential to reduce poverty, and which operates in developing countries. There are two

1) Examples of this are found in health (e.g. treatment for cancer); forestry management, education, etc.

2) See further www.tillvaxtverket.se

application processes; one for small grants up to EUR 20,000 and one for large grants EUR 20,000 - 200,000. (SEK 170,000 – 1,7 million). Grants are awarded to the best business plans which meet the criteria of the program. IAP also contains a third element, allowing for guarantees in line with Sida's guarantee programme. The IAP is managed for Sida by a consortia led by Price Waterhouse, who won the management contract through an international bidding process. Since the launching, two rounds of competitions have been concluded. IAP has an initial funding of SEK 51 million for 2011-13. IAP has so far not been subject to any independent review[3]. IAP funded 35 companies its first 18 months of operations.

2.3. The Africa Enterprise Challenge Fund which started operations in 2008 provides grants and conditional loans[4] to businesses who wish to implement innovative, commercial viable, high impact projects in (sub-Sahara) Africa. The AECF supports businesses working in agriculture, financial services, renewable energy and technologies for adapting to climate change. It also supports initiatives in media and information services where they relate to these sectors. AECF has several windows with different focus, criteria and application rounds, some of which are country specific, other that are focused on themes such as agro businesses. For example, there are windows for South Sudan; Agribusiness Tanzania; Renewable energy; Agribusiness Africa; and Post-conflict countries. Applications are assessed during competitive rounds which each have their own entry criteria. Grants and repayable loans are provided between USD 250,000 to 1.5 million (SEK 1,7 million – 10 million.) The competition is open to companies from anywhere in the world provided the business idea is implemented in Africa. Thus, companies might be large multinational corporations. The fund is financed by AusAid, Danida, DFID, the Netherlands Ministry of Foreign Affairs and Sida with a total funding of USD 120 million. The fund is a special partnership between Alliance for a Green Revolution in Africa (AGRA)[5] and the donors. AECF has appointed KPMG as fund manager. Sida's contribution to the USD 120 million AECF is SEK 130 million for the period 2012-2017[6].

AECF was reviewed in early 2011 after 3 years of operation by independent consultants (Slegtenhorst & Whiteside). By then investments had been made in 48 projects in 16 countries. The review concluded that:

"AECF has developed rapidly with impressive achievements in the first three years. The Fund management has developed effective systems for attracting applicants, selecting the best business ideas and managing an exciting and diverse portfolio. This has been underpinned by an effective investment committee. The existing portfolio has the potential to deliver significant development impact, systemic change and learning."

Nevertheless, the review also had some critical points:
- The governance body comprising donors and AGRA has not functioned as envisaged, and had drifted into micro-management rather than strategic oversight;
- The fund management was considered too risk-avoiding, partly as a result of insufficient donor understanding of business risks;
- There were too few indigenous African entrepreneurs participating (versus e.g. multinationals), probably due to the minimum size of the matching grant.

3. HOW TO DESIGN A CHALLENGE FUND

Important design and management issues to be considered in setting up a challenge fund are elaborated below:

3.1. The purpose It is critical that the rationale for the CF is clear and explicit both to justify donor funding and to provide a high degree of transparency in the application and selection process. As can be seen in the examples in annex 1, the purposes of a CFs can vary widely. A leading principle in defining the purpose of a CF should be that it addresses a key development issue which otherwise is not addressed by market forces, and also that there is a clear benefit in applying the CF model versus other forms of donor support. CFs tend to be administratively demanding to manage, hence there should be clear advantages for a CF as compared to other modes of donor support to justify the costs implied in it. Three generic criteria which should be applied in the design are:
- *systemic impact* (that there is potential impact beyond the micro level, for example in structural changes in an economy through innovations or demonstration) ,
- *additionality* (it should be clear that the development would not have taken place anyway, for example through market forces and/or commercial financing); and
- *positive externalities* (that the positive effects and benefits of a project goes beyond what can be captured by a commercial entity). '

3) See further www.sida.se/iap or www.innovationsagainstpoverty.org
4) Interest free loans which are repayable when the underlying project is successful (a model which has been used by Sida in the past in different context, and innovated by Swedcorp in early 1990s)
5) AGRA is a USD 400 million multi-donor facility with support from DFID, Danida, Sida, FAO, IFAD, IFC, Melina and Bill Gates Foundation, Rockefeller Foundation, Millennium Challenge Corporation, etc., with the purpose to achieve a food secure and a prosperous Africa through the promotion of rapid, sustainable agricultural growth based on smallholder farmers.
6) See further www.aecfafrica.org

3.2. Applying different windows Some large CFs, such as the AECF and Grand Challenges Canada, have established different windows under their broad purposes in order to tailor the fund to specific targets. The advantage with such an approach is that a CF can be larger, thereby reducing management and transaction costs, yet have clear targets in its applications. It can also allow less frequent rounds of competitions for specific purposes if the supply of applications is limited. While a large fund can reduce the share of management costs, there are, on the other hand, issues in governance especially if several funders participate. AECF is an example of this.

IAP CRITERIA

1. **Clear commercial driver and potential for commercial viability**
2. **Potential to reach scale**
3. **Managed by a company or a market oriented organisation**
4. **Poor people benefit (income, products, environment, opportunities, gender equality)**
5. **Avoid negative effects (environmental, market distortion)**
6. **Clearly defined elements of cost-sharing (With the company itself providing at a minimum 50% - which should not come from other public financing)**
7. **Innovative; going beyond what exists now, in terms of the product /service, the delivery mechanism/business model and/or market reach**
8. **Project would not take place at the same scale or have the same development impact without IAP funding**

3.3. Who is eligible to apply? The criteria for who is eligible to apply for the CF vary to a great extent among existing CFs. Thus there are CFs open only to for-profit private companies, such as the AECF, while Sida's IAP allows both companies and other organizations with a commercial orientation to apply. There are examples of CFs only for NGOs. Some CFs allow only own country organizations to apply (such as Sida's Demo Environment and some smaller DFID CFs as indicated in the annex 1), while for example IAP and AECF are open to applicants globally. In some CFs, applicants residing in developed countries are eligible to participate, but are obliged to spend a certain share of the funds in the targeted developing country for the CF.

3.4. Eligibility criteria in terms of a proven record by a company or organization, a certain time in existence, a clean legal and ethical record etc., are general among CFs and necessary in order to reduce risk for fraud, improve the chance the applicants have capacity to succeed and to reduce reputation risks for the donor. Common minimum criteria for participation might, for example, be that the organization has judiciary form; that it has been in existence for a minimum of 2-3 years, it has audited accounts for that period; is not placed in bankruptcy; it has an established CSR policy, not engaged in activities such as arm production or tobacco, and has a financial position which makes it likely to be able to sustain a project, etc.

3.5. Selected countries The geographical areas or countries that are open for a CF might range from narrow definitions of only one country to all developing countries. DFID, for example, has or has had funds specializing on a single country (Ghana, Vietnam, and Afghanistan). (Sub-Sahara) Africa tends to be the focal point in some CFs, reflecting development needs of the continent. Some CFs have a different regional focus on selected countries and poorer regions in countries, such as the AusAid Enterprise Challenge Fund with nine defined countries in Asia-Pacific. The Sawaed Programme is open for 22 countries in the Arab League, while the Enterprise Innovation Challenge Fund is specialized on the Caribbean. As noted above, the Sida CFs have different focuses: Demo Environment is focused on seven partnership countries; IAP focuses on all LDCs and low income countries; and AECF all countries in Sub-Sahara Africa. (Also note that IAP has set up a special window for the MENA region.) CFs specializing on a narrow geographical region or a single country, have the advantages of a potentially greater impact locally, tend to be more easy to manage and supervise, but run the risk of having too few applications of sufficient quality. The targeting of countries/regions will of course have a bearing on the size of the CF and other criteria.

3.6. Additionality The criteria against which applications are judged and rated must transparent and clear. The IAP criteria provides a good example of donor rationale, see box. Especially additionality is a key criteria: a fund that provides grant financing to projects which anyway would have taken place through private capital has wasted its resources. Additionality is often linked to risk, i.e. a private company would not engage in the project alone due to high perceived risk. The willingness of a CF to take risks tends therefore to be a key issue of the development performance of a CF. Development effects are of course the main rationale for a CF where potential for systemic impact and positive externalities are generic criteria as mentioned above.

3.7. Specific targeting Some CFs define specific targeted challenges within the overall framework of the CF for a round. This is, for example the case with the DFID Vietnam fund and the Sawaed program (see details in annex 1). Such additional targeting adds value in the sense of making applications more easy to compare and rank.

3.8. Fund size and donor costs There are two key types of costs involved in a challenge fund for a donor: 1) the total amount which will be provided as awards over the time of the fund; and 2) the management cost of the CF, including marketing, cost of an independent investment committee, a potential independent monitoring and/or evaluation team, etc. As noted in the examples in annex 1 the total budgets vary from about SEK 20 million to SEK 1,5 billion. DFID had in its earlier CFs budgets of about GP 15 million (or SEK 150 million).

3.8.1. Fund period For practical reasons, CFs are limited in time, for example they will be operating for 3 years with a specific number of challenge rounds. There is nothing to prevent a fund to be extended in time (possibly requiring additional funding).

3.8.2. Maximum grant size Challenge funds undertaken by DFID, AusAid and USAid award grants of up to USD 1,5 million (about SEK 10 million) per project, and even more as is the case in one of USAid's CFs which in a three stage process can provide a grants of up to USD 15 million for a project (see annex 1). Sida applies a much more restrictive upper limit of EUR 200,000 (appr. SEK 1,8 million) in both the IAP and Demo Environment, using the formula for allowed limit for public support to commercial entities within the EU legal framework. However, indirectly in Sida's support to AECF, the upper limit of USD 1,5 million applies also for EU registered companies. The legal aspects are unclear in this respect for EU companies under the AECF. A challenge fund is a competition among applicants for a specific development objective, hence it could be argued that there is no more market distortion in a CF than in any competitive bidding process undertaken by a government authority for a specific project.

3.8.3. Minimum grant sizes are established to reduce unfavorable transaction costs for both parties. There is in general a high cost involved in managing CFs and in the processing of a grant whether small or large. The applicants also have an administrative cost of filling applications, managing a project and reporting, making too small grants of limited interest. AECF has a lower limit of USD 250,000 (about SEK 1,7 million) while Sida's IAP has no such lower limit and rather encourage smaller applications through its small grant facility (with EUR 20,000 as an upper limit). IAP stands out among the examples in annex 1as a CF with an overall small grant level.

There is nothing to prevent also smaller grants within reasonable transaction costs if the application process and handling of applications are streamlined and simple. There might be a merit for smaller, simple application processes in a CF focusing on earlier stages in commercial processes where risk often is perceived as high. As shown in annex 1, the model applied by USAid's Development Innovation Ventures is based on a three stage process with at least in theory small support from early feasibility to large scale support for the global distribution of a specific project or idea. In the review of the AECF it was concluded that a high lower limit (in this case USD 250,000) might favor multinational companies and discourage indigenous African entrepreneurs (due to the required matching funding).

3.8.4. Repayable loans The CF might not only provide outright grants, but also other forms of contributions. Repayable loans meaning that a loan is due to be repaid only if a project is commercially successful, otherwise it is written off, is one model applied by the AECF. While such a model is administratively more complicated that a grant, and might have a 'perverse incentive' (as an applicant might have an incentive to show failure), it adds donor leverage (in the sense that a donor budget can support more projects). The conditional loan has also a value in a sense of making commercial risk-taking explicit.

3.8.5. Cost-sharing All business oriented CFs apply a cost-sharing formula, most of those included in annex 1 stipulate that the applicants must provide at least 50% of the 'project cost' from own resources. There are variations, however, including up to 80% funding by some CFs (for example the Sawaed fund. In the IAP the degree of cost-sharing is a criteria in the competition. In Sida's Demo Environment there are different criteria applied whether the applicant is a private company or a public institution with more requirements on the private company.[7] Cost-sharing is applied as it creates commitment by the applicant and also provides leveraging of donor funding. An essential matter to keep in mind is that for example in innovation processes, there tends to be heavy investments required in post-laboratory and trial stages in establishing marketing, distribution etc., requiring capital muscles of a company.

7) A private company cannot include own labor as an element in the calculation of own input, nor include this in the costs covered by the grant.

IAP (INSTRUCTIONS)

Core business costs (e.g. existing staff time, planned new staff time, or other costs that are already committed to or planned)

External advisory costs (e.g. consultancy support, advisory inputs etc.)

Other expenses (travel, workshops etc.) We would expect Capital Expenditure to be largely funded by the company

3.9. What are project costs?

An important question is what are the costs that can be calculated as a basis for an application, i.e. what can be counted as a 'project cost' and be (part) financed through the grant. In the IAP the instruction are fairly open, while in a DFID fund, there is a more restrictive list of what cannot be included as indicated below:

3.9.1. Dealing with 'sunk' costs In almost all cases, applicants have 'sunk costs' for a project i.e. investments undertaken prior to an application, but which are necessary for the project as far as it has been developed. As a general rule in CFs, sunk costs cannot be included in an application, neither as a part of the applicants matching fund, nor for refunding. Such rules must be made explicit in the application process.

DFID FUND LIST OF WHAT CANNOT BE INCLUDED:

- Land purchase
- Property purchase or construction costs
- Major capital expenditure
- Inflation must not be included as a stand alone, separate budget line
- Core costs (both UK and overseas): These are costs which are not directly related to the implementation of the project, e.g. costs for staff and office rent beyond what can be associated with the project.
- Contingencies: Unforeseen costs arising during the project implementation will be considered on a case by case basis and must not be included as a separate item in the budget
- Depreciation: This is a bookkeeping transaction rather than an actual cost and must not be included
- Debt Repayment
- Design costs, baseline surveys etc.

3.9.2. How should costs be calculated? When cost-sharing is required a technical issue is how the applicants' contributions should be calculated. Often these costs are provided in-kind, not least inputs of management and professional time. How should such professional time inputs be calculated and at what hourly or weekly rate? If the applicant is providing material and factory/office space, how should such costs be enumerated? A standard rule is that time inputs are calculated pro-rata, i.e. the real cost to the company. Making it clear and explicit in the application process what costs which are eligible and which are not, how such costs should be calculated, etc., will reduce uncertainty and transaction costs in the process.

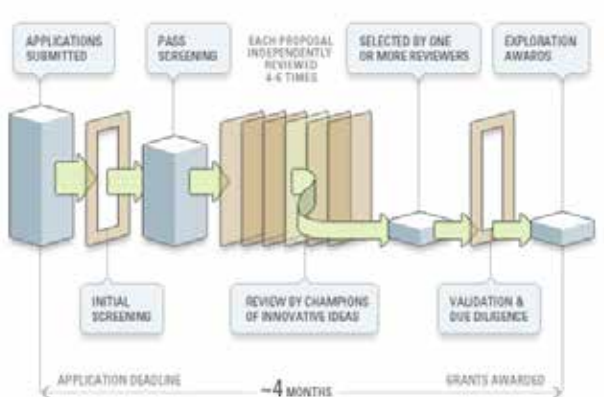
3.9.3. Cash contributions A linked question to the one above is whether the CF should require a minimum cash contribution as a requirement in the co-financing or not. In some of the funds discussed in annex 1, such a criteria is applied. Cash contributions might be seen as a sign of commitment by the applicant to the project and such contributions are also more easy to calculate.

3.10. Technical assistance A CF might have a complementary technical assistance component as a means of assisting applicants in developing business plans, streamlining project proposals, or providing general business advice. The IAP has an element of this by including a limited number of hours of business advisory offered to large grant of applicants free of charge. The Sawaed program has an explicit support to applicants from the fund manager, but also from a predetermined list of business mentors (paid for by the fund). The use of technical assistance or not, depends to a large extent on the fund. If the majority of applicants are smaller companies and organizations, a technical assistance window make good sense.

3.11. Number of 'openings' per year A challenge fund must have specific closing dates for applications. The number of such rounds varies between the examples in annex 1, but tends to be once or twice per annum. A limited number of closings makes a CF simpler to administer and might also be justified due to the number of potential applications. It must be recognized that an application process has several (time-consuming) stages in the announcing – review – supervision process, also a reason for limited number of rounds.

3.11.1 The application process Challenge funds are based on competition, hence require clear and transparent systems for applying and selecting of winners. Many CFs have a two stages process in order to reduce administrative costs. Thus, the first stage usually requires a simple application (such as a 1-2 page concept note) from which a short-list is made by the fund (or an investment committee). The short-listed candidates are then asked to put in full-fledged applications, often with a business plan as a format. Among the full-fledged applications, an investment committee, sometimes including donor representative, selects the winners based on the criteria established.

Below is the application and approval process applied in a CF operated by the Bill and Melinda Foundation *Grand Challenges Explorations initiative* (see details in annex 1):



3.11.2 Using online applications All documents required for the application, including eligibility criteria, forms, etc. should be available online for downloading and preferably also for direct electronic submission. It should be taken into account that there is a trade-off between complicated application forms allowing detailed information for the fund to make decision, and the appetite for a company to apply, especially for smaller grants. Some CFs apply an unorthodox process in application, for example using YouTube videos such as Grand Challenges of Canada.

3.12. Fund management Donors often outsource the management of the challenge funds to outside organizations in view of the fact that the funds are demanding in administrative resources. Such outsourcing is normally done through competitive bidding. In the case of DFID, major UK based consultancy firms such as KPMG, Landon Mills, Coffey International and Nathan Associates are fund managers for the various funds. In the two 'Swedish' CF's, the IAP was subcontracted to Price Waterhouse after a competitive bidding process, while in Demo Environment the management has been subcontracted to Tillväxtverket.

3.12.1. Management costs The cost of management is generally not transparent in the public information. In the AECF the fund management fee is 20% of the total budget, with 17% of which an additional 3% for AGRA management. In the AusAid ECF, the management fee, including costs for an independent monitoring team and marketing of the fund, is 30% of the total fund over a 6 year period. In the IAP the management fee to PwC is about 50% of the total donor funding over a 3 year period. Two more important reasons are that IAP is mostly attracting young companies as well as NGOs to apply, which are relatively inexperienced, needing a lot of support for contracting and reporting. Secondly, setting up all processes and structures aslo have a relatively high initial cost (since this is mainly a fixed cost it makes the % management fee high for a small fund) which is not reflected in the current management fees of for example AECF where they have passed this stage. The high relative cost in IAP may be explained by the fact that it includes some technical support to applying companies by the management company, and also that IAP - as compared to AECF and ECF- is small with on the average quite small grants to entrepreneurs and companies. A designer of a CF might choose in a competitive bidding process of predetermine the management cost, or use this is a part of the competition.

3.12.2. Performance based fees Fees can be linked partly to performance, which is the case in the AECF. Such performance fees can be related to output (level of grants), performance indicators established beforehand, annual targets, etc.

3.12.3. Investment committees/external review panels Independent of the fund manager and the donors are often established by the CFs to judge and select among applications. Such committees should preferably include specialists in the field of the fund. Such a committee can also add prestige to a fund, hence attract more and better applications. The committee must base its decisions to be fully independent of both donor and fund manager on clear criteria and professional judgments. Especially if there is a performance payment to the fund manager, independence is critical.

3.13. Marketing Challenge funds depend on attracting good applications from a wide range of organizations and businesses, possibly in a global setting, require active marketing to make the fund known. Such marketing can be done by donors and by fund managers in combination, and even by using specialized marketing agents. Cost for marketing can be considered a management fee of the CF. Publishing the availability of a CF on a donor's web-page is not sufficient as the CF normally is targeted at organizations organizations who have no or limited exposure to these organizations. IAP has applied a 'road show' approach with some success. A well-developed and easy to find web page is also a must.

3.14. Avoiding corruption and malpractices A CF must have zero tolerance of corruption which should be clearly signaled in publicity materials and contracts. An anonymous fraud reporting procedure for example with button on the website, can reinforce such message. The 'due diligence' of granted projects and the applicants is a critical procedure to minimize the risk of fraud. Minimum standards for accepted applicants which are followed up before a grant is awarded are also a means of reducing risks for corruption.

3.15. Monitoring Fairly complex systems for M&E tent to be established for CFs, reflecting both the delegation to external organizations and that private sector development have their own issues. In the AECF an elaborate, hands-on system has evolved. Fund management should have a lead role in monitoring of the CF in the sense of follow up of supported projects, to the extent these deliver in line with expectations and reasons for deviations. Fund management should also have the fiduciary monitoring responsibility. Monitoring should be seen as an integral management tool and need to be complemented by a system to assess development impact, cost effectiveness and learning.

3.16. Results-analysis and impact assessment A CF should ultimately not be judged on the applications which are granted awards, but on what the projects achieve in terms of systemic development impact with a bearing on poverty (or other overriding developmental objectives). There is obviously a time lag in this in the sense that the ultimate results will not be available until some years after the provision of the grants. Information for results analysis should be provided by the fund management, but the assessment has to be independent. The standard evaluation criteria should apply, i.e. relevance (are the funded projects addressing the purpose of the fund?), impact and effectiveness (what is in fact achieved along the purpose of the fund?); efficiency, or even better cost-effectiveness (the ratio between the donor inputs, including all management costs and the value of the achievements), sustainability (if the projects are likely to be self-sustained commercially). The Australian ECF is a good example of CF which has taken impact assessment seriously by funding an independent monitoring team parallel to the fund management; initiated an independent mid-term review after 3 years, and also providing public annual reports of the fund.

3.17. Systemic impact CFs are dealing with projects at the 'micro-level'. Even if a project is successful both in delivering commercial returns to the applicant and development effects at the micro level (such as added employment) this is rarely sufficient to justify donor funding. CFs must strive for systemic impact, i.e. a project must have the potential for development impact at a 'higher' society level, preferably at macro level. Examples of this are that a CF supports an innovative break-through which is replicated by other organizations. Assessing systemic impact can be done both ex-ante and thus influence investment decisions (what are the likelihood for such systemic impact?) and ex-post (to what extent has systemic impact occurred?)

4. A POTENTIAL SIDA GRAND CHALLENGE FUND?

The Challenge fund concept is an innovative and potentially cost-effective means of development assistance. However, they can be administratively demanding to do right and the CF design and management is also an 'art' in rapid development. In the light of that, we propose the following:

Establishing a detailed general Sida framework for CFs, possibly in the form of a Grand Sida Challenge Fund. The latter would have different windows where specific ideas and needs can be applied by departments in Sida and/or the Swedish embassies as these emerge. This framework (or Grand CF) would provide a common administrative and management structure with the purposes of: 1) stimulating the use of CFs in Swedish development assistance; 2) reducing the administrative burden on designing and implementing CFs; and 3) assuring that that 'best practices' are applied and 4) facilitating that there is system of in-built learning in the use of CFs.

The framework (or Grand CF) would provide detailed guidelines and templates for required forms. If the Grand CF model is applied, it could also provide an overall management structure for running the various windows under it. Such management would be sub-contracted through a competitive bidding process.

Another feature of the framework would be provision of technical back-stopping to the specialized CF windows. If the Grand CF concept is used, such technical support would be an integrated part of the management.

Ultimately, any embassy or department in Sida, should be free to focus on the development issue for which a CF could be used, provide thoughts on criteria and targeting, but not to have to spend considerable time and resources to learn the techniques and to set up complicated procedures for implementation.

To facilitate the process and test the validity of the Framework/Grand CF, your idea on development issues for CFs are most welcome.

5. LESSONS LEARNED FROM CHALLENGE FUNDS

Key lessons learned from the CFs over the last decade are summarized below:8

- CFs have evolved to include a variety of approaches, from small specialized CFs focusing on a single country (for example in Afghanistan , Vietnam and Ghana) or a narrow theme (such as labor conditions in the garment industry) to large scale Grand CFs with broad purposes and several funding windows. Both kinds have been designed recently. There is an argument among CF practioneers that more specialized funds have a merit in the sense of management and professional inputs. On the other hand, a too narrow focus – for example on a single country - might not attract sufficient quality in applications. For example a CF promoted by DFID in Ghana in the early 2000s had to be closed down prematurely for that reason.

- There seems overall to be a positive assessment of the CFs in the sense that most of the funded projects are achieving stated objectives. Additionality (i.e. that the CF is stimulating development which otherwise would not have happened) appears to be satisfactory. However, there is yet little evidence on systemic development impact beyond the micro level, i.e. to what extent the supported projects stimulate structural changes in the economies with potential impact on poverty.

- Leverage of private capital through the CFs varies greatly from 1:1 to 1:4, to a large extent dependent on the size of the companies participating. CFs engaging multinationals (such as most of the DFID funds) have overall a much higher leverage than those focusing on SMEs.

- The focus of the available reviews of CFs so far is more on management issues than impact analysis of underlying projects. To some extent this is due to the time-lag required for projects to mature to allow impact analysis. Some reviews highlight significant management issues, for example in the AECF and the ECF, both started in 2007-08.

- Delegation of fund management to independent organizations such as consultancy firms through competitive bidding processes appear overall to have worked well to ensure professional management of the funds; any management issues seem rather to have emerged in the donors' role.

- Well marketed CFs usually receives a large number of applications per round of which only a small number can be selected due to funding restrictions. A ratio of 1- 2 awards to 50 applications seems not uncommon. This requires an efficient mechanism for screening applications to minimize transaction costs both for the CF and the applicants. The dual system of an initial concept followed by fully developed proposals based on shortlisting is generally applied. The management of the funds is, nevertheless, demanding, implying management cost in the order of 20–50% of the total budget allocation.

- An important rationale for companies to participate in challenge funding appears to be access to risk-willing capital, rather than the access to subsidized or 'free' money. Hence repayment might be less of an issue, making alternatives to grant such as conditional loans of interest in order to increase leverage of limited donor funding.

- Sida applies a much more restrictive across-the-board upper limit on grants in its 'own' funds (Demo Environment and IAP) based on Sida's interpretation of the EU regulations on accepted state support to commercial entities, which other EU members do not apply (such as DFID). The application of the EU rules to challenge funds is not fully clear. As the support is provided in a competitive setting where all market actors are eligible to participate, an argument could be that EU regulations should not apply.

6. ANNEX 1: EXAMPLES OF DONOR FUNDED CHALLENGES FUNDS

The challenge funds listed below are presented in chronological order:

Financial Deepening Challenge Fund (FDCF) is one of the first DFID challenge funds, operating between 1999 and 2007. Its purpose was to increase access to finance for poor people in selected countries in Africa and Asia through innovative, commercially viable financial products, including insurance, house financing, pensions, etc. It was open to financial institutions, including banks and multinational companies on a cost-sharing basis (with at least 50% provided by the applicants). The fund was in total £15 million and grants were provided in the range of £ 0,5 million to £ 1 million per project. The fund was open to all developing countries. A two-step process was involved, first a short concept note, then a full application. FDCF was one of DFID's first challenge funds.

28 projects in 15 countries were funded. Of these 19 were in Africa. The average grant size was £ 0,5 million, and the fund had a leverage effect of mobilizing £ 56 million in private funds. Most of the companies awarded grants were multinationals such as Vodaphone; Tata, AIG and Deutche Bank. There are claims by the companies that the projects would not have taken place without the CF due to risk. Of the 29 projects funded, 9 achieved high social impact combined with high financial returns whilst the majority achieved a combination of reasonable social and financial returns according to external assessment. Examples of project details are provided on web-page.

Business Linkage Challenge Fund funded by DFID operated between 2000 and 2008. It made grants for the development of business linkages that improve competitiveness and benefitted the poor. Linkage projects were eligible for support provided that the linkages demonstrate real innovation and help the poor for example by transferring skills, information and technology, improving sourcing, product supply and market access. The fund provided grants from £ 50,000 up to £ 1 million. The £ 15 million Fund was open to any registered private sector enterprise, as well as to business and civil-society organizations in the UK and selected countries in Africa and the Caribbean. Fund management was undertaken by the Emerging Markets Group. BLCF was also one of the earliest DFID challenge funds.

The fund financed 59 projects in agriculture; health care, manufacturing and tourism in 27 countries in Africa, Asia and the Caribbean; it was claimed to have created 9,000 jobs and 100,000 indirect jobs. The leverage effect was 1:2 with private sector investment of about £35 million. Initially open only to SMEs, but later changed. Companies such as Unilever participated. The BLCF receives approximately 200 Concept Notes per bidding round. The Panel recommends 5-10 per round be allowed to proceed to Full Application, and approves 3–7 of these, i.e. there was a ratio of 1 grant to about 50 applications.

ProPoor Innovation Challenge (PPIC) is a challenge fund established by CGAP in 2002. It funded smaller institutions that demonstrate effective models and methodologies for deepening poverty outreach and impact, while working toward sustainability. The PPIC awards, of up to $50,000 to five institutions per round, were to be used for technical assistance and other expenses related to the specific pro-poor program. A parallel fund was the Rural ProPoor Innovation Challenge in which IFAD joined CGAP. CGAP and IFAD jointly selected the winners based on the following criteria: depth of outreach; innovation and effectiveness in client identification; delivery methodology; product/service design; and demonstrated commitment to both the proposed project and eventual sustainability. Rural innovation was the particular, although not exclusive, focus of this funding round. By 2008 PPIC had gone through nine rounds.

The **Enterprise Challenge Fund** (ECF) was set up in 2007 by AusAid and focuses on the Asia Pacific region. The Fund was planned to operate for 6 years with a total allocation of AUSD 20,5 million. It provided matching grants (up to 50%) to commercial companies for poverty oriented projects in new markets. Grants between AUS 100,000 to AUS 1,5 million were awarded. The fund was open to nine countries or part of countries in the Asia Pacific region, including Lao, Cambodia, parts of Indonesia and the Philippines, and small island states such as Fiji, Vanauta and Solomon islands. Any business could apply for funding providing they legally operate in the country where the business project will be implemented. The key criteria for grants were:

- Business growth and sustainability of the project. A key criteria is that a supported project can be sustainable within three years.
- Increased social and equitable development for project beneficiaries.
- Wider systemic impacts including replication, crowding in and scaling up.

The ECF was outsourced to Coffey International Development for fund management. An independent monitoring team was also part of the set-up. 30% of the fund was allocated fund management, monitoring and marketing costs. The ECF provides considerable public information through annual reports, a website and an independent review in 2009, placed on the web. See further www.enterprisechallengefund.org

ECF was subject for a mid-term review in 2009 conducted by the UK based Springfield Centre. While by then 21 projects had been awarded grants, the results of these were yet too early to assess according to the review. As a result of this assessment, AusAid concluded that it:

> *"agrees with the review's recommendations not to invest any further funds into the current ECF until project impacts are better known. It will continue to track development impacts of projects through annual impact data provided via its independent monitoring team and a further independent review (scheduled for late 2011). AusAID will also explore how support for challenge funds which have a tighter regional and/or sectorial focus may provide opportunities to strengthen Australia's development outcomes."*

In the end of 2011 a second review took place, a report which has not yet been made official.9 As of 2012, ECF has 21 projects in its portfolio and have used the full grant sum of AUS 14,5 million. About half of the projects are in agro business. ECF's annual report 2011 claims employment creation of about 35,000 directly and with an outreach of 150,000. 15 of the 21 projects are meeting the established targets. The assessment is that only 2 projects are poor performers. For the annual report 2011, see 2011 Annual Report.

The **Food Retail Industry Challenge Fund** (FRICH) was set up in 2007 by DFID and is still ongoing. FRICH aims to improve the lives of these farmers and workers, by increasing European imports of food from countries north of South Africa and south of the Sahara. FRICH supports new ideas that connect African farmers with global retailers in innovative business partnerships. The fund is managed by the UK consultancy group Nathan Associates. FRICH has so far after 3 rounds supported 11 innovative partnerships, in Kenya, Democratic Republic of Congo, Malawi, Rwanda, São Tomé and Principé, Ghana, Uganda, Zimbabwe and Ethiopia. These partnerships focus on tea, coffee, a chocolate drink, fresh produce, berry fruits, juice/smoothies, flowers, tilapia fish and vanilla. The granted projects include large UK partners such as Sainsbury and Marks and Spenser. Projects displayed on the web.

Enterprise Innovation Challenge Fund (EICF) is a specialized fund on the Caribbean region supported by IDB, Canada and DFID in partnership with Caribbean Development Bank. Any private firm or partnership of firms that includes at least one company registered in the Caribbean can apply. International firms can be involved as partners in projects. The firms must have an innovative business idea that meets the challenge and have resources available to match the amount requested (between USD $100,000 and USD $500,000). There are two stages, one for the development of the Project Concept Note and the other for the preparation of the Innovative Business Project. The Enterprise Innovation Challenge Fund is a matching grant facility, which provides an opportunity for businesses in the CARIFORUM region to enhance efficiency, productivity and innovativeness. The EICF-SCI has two distinct means of providing grants to firms that are registered in beneficiary countries. Financial support is given to: Clusters and sectors' value chain to improve their capacity and performance; and to Small and Medium Enterprise (SMEs) to improve their competeiveness at the regional and global levels through product/service development, innovation and diversification. www.competecaribbean.org

Grand Challenges Canada (GCC) In 2008 the Government of Canada established the Development Innovation Fund to "support the best minds in the world as they search for breakthroughs in global health and other areas that have the potential to bring about enduring changes in the lives of the millions of people in poor countries." The Government of Canada committed C$225 million over five years to the Fund. It is implemented by the non-profit organization Grand Challenges Canada. It has the objective of identifying global grand challenges, fund a global community of researchers and related institutions on a competitive basis to address them, and support the implementation/commercialization of the solutions that emerge. It is open to Canadian applicants and applicants from low and middle income countries in different windows. There are two basic funding mechanisms; 1) Proof-of-concept proposals with grants of up to C$100,000; and 2) scale-up grants of up to C$1 million. Co-funding is required, and for Canadian applicants at least 30% should be spent in developing countries. There are four windows in GCC, called 'Stars in global health; Point of care diagnosis; Maternal, neonatal and child health; and Non communicable diseases. See further www.grandchallenges.ca

COOP Africa Challenge Fund, operated by ILO with a total fund of USD 3 million, started in 2008. It is set up to be a demand-driven program, giving national cooperative movements influence on how to invest the funds available. Cooperatives, cooperative apex organizations and other cooperative support agencies from the project countries can apply for a grant in the size of USD 20,000 to USD 50,000. Also smaller projects below USD 20,000 can apply for funds throughout the year. Application forms, budget templates etc are available on-line. See further www.ilo.org Since its inception in June 2008, the COOPAfrica Challenge Fund has funded about 70 projects in Eastern and Southern Africa. COOPAfrica held fifth calls for proposals in 8 countries under this facility. Through the calls, more than 600 applications were submitted and over 60 organizations have already been selected for COOPAfrica grants, for a total funding of approximately US$ 3,000,000. Examples of projects are provided on ILO's web-page.

Financial Education Fund (FEF) began in 2009 and is still in operation. It is designed to support innovations which improve financial literacy to increase access to financial services for the poor in Sub-Saharan Africa. The fund aims to encourage innovative ideas. Grants of up to £250 000 are awarded. Financial education can be delivered through a range of channels, from those targeting the general public to interventions targeting smaller groups. However, projects must have the potential to reach large numbers of people, directly or through multiplying factors. The first round was open to eight Sub-Saharan African countries: Botswana, Ghana, Kenya, Namibia, South Africa, Tanzania, Uganda and Zambia. The FEF awarded grants to 15 recipients in eight African countries. The Financial Education Fund is conceived as a multi-donor fund with initial start-up capital from DFID over three years.

Vietnam Market Participation Challenge Fund was established by DFID and ADB in 2009 to operate for two years with a total fund of USD 3 million. The fund awarded grants for up to 49% of the project cost between USD 30,000 – 250,000. The CF is a part of a larger and longer term Market for the Poor initiative by ADB and DFID. The fund, open to any company, NGO or organization registered in Vietnam, supports innovative projects benefitting the poor in agriculture, with some specific challenges in the first round such as 'increased participation in higher value agriculture for exports.' In its first round it received 200 applications, and awarded 12 projects.

The **Sawaed Programme** is a CF established 2009 and run by the Mohammed bin Rashid Al Maktoum Foundation focusing on the Arab world. The CF seeks to support and develop the capabilities of talented Arab entrepreneurs by awarding non-refundable grants to regional projects that make a positive contribution to Arab World development. The fund is open to companies in 22 countries in the Arab league. Each year, Sawaed addresses a specific regional challenge, inviting participants to submit business concepts dedicated to meeting that challenge. The will select winning business concepts and will help fund these concepts as per certain timelines. An example of such a challenge is "access to high quality online Arabic content and ICT resources that support education and learning and which promote Arab culture." The Sawaed Programme offers grants to eligible applicants ranging from AED 100,000 to AED 1,000,000 (appr. SEK 190,000 to SEK 1,9 million). The applicants must provide a minimum of 20% own financing. The fund uses a two stage process (concept note and full application) and provides technical support in filling in application both through the fund management and a special mentor program. See further www.mbrfoundation.ae

The **Responsible and Accountable Garment Sector Challenge Fund (RAGS)** funded by DFID which started in 2010, supports projects aimed at improving conditions of vulnerable workers in the ready-made garment production sector. The fund aims to benefit workers in low- and lower-middle-income countries in Asia and Sub-Saharan Africa that supply the UK market. The fund provide matching funds to non-governmental organizations, both for-profit and not-for-profit, associated with labor conditions in the garment sector in poorer African and Asian countries supplying the UK market. The fund manager is the UK consultancy group Maxwell Stamp. Performance criteria has been defined as To monitor progress of supported projects and to gauge their impact, the following ILO Decent Work indicators will be used to track performance together with other project-specific indicators:

- number of workers affected/reached (measured by type of work and gender of worker)
- percentage of workers receiving at least minimum wage (as defined in the relevant country of intervention)
- percentage of workers receiving overtime due
- percentage of workers working more than 60 hours per week
- percentage of workplaces audited showing incidence of child labour

RAGS has so far supported 12 projects in Bangladesh, India, Nepal and Lesotho. See further www.dfid.gov.uk/ragschallengefund

Development Innovation Ventures (DIV) In 2010 USAID launched the DIV which awards grants to new development solutions, tests them, and helps scale those that are proven successful. The Fund works in three competitive stages: stage one provide grants of up to USD 100,000 to support proof of concept and feasibility; stage 2 provides grants up to USD 1 million for support of transition of innovations to widespread adoption throughout one country and/or additional adoption in other countries; and stage 3 have grants between USD 1-15 million for scaling up proven, successful projects to be mainstreamed around the world or at least throughout a continent. In all stages the principle is competition between projects. DIV "seeks solutions that are several times more cost effective than current practice. These ideas do not have to be technological solutions, but also new business models, new processes, or even novel combinations of tried and true techniques… solutions potential to scale big, to tens of millions of beneficiaries within ten years." The DIV is open to enterprises, universities and other organizations globally with US political restrictions. See www.usaid.gov.div

Grand Challenges for Development Initiative (GCDI) is a new USAid initiated CF, focusing on removing critical barriers to development progress and facilitates innovative approaches, particularly those based in science and technology. It is 'meta' fund, envisaged to include a series of different CFs. Example of these is a challenge fund for Powering agriculture. It will focus on identifying and overcoming specific, critical barriers to off-grid access to clean energy for agricultural processing, pumping, and storage in energy poor communities in the developing world. The Fund aims to provide USD 25-30 million from several donors. The Grand Challenges for Development Initiative also includes a fund called Saving Lives at Birth focusing on maternal and child health. It was launched in 2011 with funding from USAid, Norway and DFID. The All Children Reading Grand Challenge for Development is another Fund under launching with support by World Vision and AusAID.

Afghanistan Business Innovation Fund www.imurabba.org (ABIF) is a new private sector investment challenge fund for Afghanistan financed by DFID, which has committed £4.8 million to incentivise private sector investment that will meet the Fund's strategic objectives. The Fund was launched in October 2011, and is due to run for 30 months. ABIF is managed by Landell Mills, an international consultancy firm. The first deadline for submission of concept notes was January 2012, resulting in more than 350 concept notes against the published eligibility and assessment criteria. After undertaking limited due diligence, the fund arrived at a final shortlist of 13 applicants.

An example on a well-established CF not focussing on private sector development is **Grand Challenges Explorations initiative**, a CF initiated by Bill & Melinda Gates Foundation. Grand Challenges Explorations fosters innovation in global health research started in 2008. The Bill & Melinda Gates Foundation has committed $100 million to encourage scientists worldwide to expand the pipeline of ideas to fight our greatest health challenges. The grant program is open to anyone from any discipline, from student to tenured professor, and from any organization – colleges and universities, government laboratories, research institutions, non-profit organizations and for-profit companies. The initiative uses an accelerated grant-making process with short two-page applications and no preliminary data required. Applications are submitted online, and winning grants are chosen approximately 4 months from the submission deadline. Initial grants of $100,000 are awarded two times a year. Successful projects have the opportunity to receive a follow-on grant of up to $1 million. Grants have already been awarded to 602 researchers from 44 countries. It is currently on round 9.

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