Research Note on Challenge Funds [1]

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Introduction

What is the objective and purpose of this instrument?

"Enterprise challenge funds (ECFs) provide grants or subsidies with an explicit public purpose between independent agencies with grant recipients selected competitively on the basis of advertised rules and processes who retain significant discretion over formulation and execution of their proposals and share risks with the grant provider."[2] ECFs invite companies working in a targeted field to submit project proposals for inclusive business models that aim to solve a specific development problem and generate high pro-poor impact. The proposals are then assessed against transparent and pre-determined criteria. Successful applicants must match a certain percentage of the grant with their own financing or in-kind contributions. ECFs can trigger new ideas and innovative solutions to pressing social issues.

In contrast to social and civil society challenge funds, ECFs promote innovation oriented to serving people living at the bottom of the economic period (BoP) and fund activities that are projected to be commercially viable without repeated subsidies.[3] They should be applied when trying to solicit new solutions to clear and well-researched challenges. To assess whether or not an ECF is the right solution for allocating public funds, it is essential to understand the target market and existing actors. Markets that are underdeveloped over overdeveloped are not ideal for ECFs since they run the risk of either not having enough business solutions or creating market distortion by externally influencing competition in local markets.

Early ECFs aimed to be light-touch solutions to catalyze risky ventures that otherwise would not materialize or would be delayed due to lack of financial capacity. Recently however, ECFs have been diversifying their objectives and level of engagement. Robin Davies and Kerri Elgar[4] distinguish two emerging perspectives of challenge funds: the "purist" approach and the "pragmatic" approach. Proponents of the purist approach adhere to the logic that managers need not actively engage in implementing projects, but should invest in prior research to understand the market and design eligibility and selection criteria strict enough to only elicit business ideas with a high potential for success and sustainability after the funding period. Purists maintain the perspective that the role of ECFs is to provide risk-reducing subsidies for projects without other forms of support such as technical assistance. Pragmatists, on the other hand, argue that 'pure' ECFs achieve very little on their own in terms of impact. They believe that in order to bring about systemic change, as this instrument is intended to do, ECFs should be embedded in larger private-sector development mechanisms or include other forms of assistance for selected businesses.[5]

ECFs can be included in national policies as part of an activation strategy or an Active Labor Market Policy (ALMP) to encourage unemployed citizens to find jobs. The Jobs Fund programme in South Africa is a prime example of this strategy in practice. As detailed later in this paper, ALMP strategies must not

[2] O'Riordan, A., Copestake, J., Seibold, J & Smith, D. 2013. Challenge Funds in International Development. http://www.tripleline.com/wp-content/uploads/2013/12/Challenge-Funds-in-International-Development.pdf
[3] O'Riordan, A, Copestake, J, Seibold, J & Smith, D. 2013. Challenge funds in international development. http://www.tripleline.com/wp-content/uploads/2013/12/Challenge-Funds-in-International-Development.pdf
[4] Davies, R., & Elgar, K. 2014. Enterprise challenge funds for development: rationales, objectives, approaches. Australian National University
[5] *Ibid.*

substitute or displace natural labour market mechanisms or become deadweight (i.e. achieve outcomes that would likely occur in even the absence of the policy).[6]

Challenge funds engage actors in development by creating a unique partnership between public and private actors, who both have a vested interest in the success of the programme. ECFs leverage donor funds by attracting private capital through matching financing and engage the private sector in achieving development goals. Public partners can strengthen links with domestic and partner-country businesses, and find local solutions to local problems without significant external influence. The competitive aspect of the programme helps public partners to elicit desired solutions by prescribing the means to achieve them and by supporting multiple winners.

Common elements and best practices

How does the instrument work?

The key feature of an ECF, which distinguishes it from other funding mechanisms, is competition among businesses. Incorporating a competitive aspect into the core design of grant funding drives ambition and creativity in the private sector. Beyond that, challenge funds aim to bring about systemic change and positive impact through novel yet commercially viable business models. To achieve this, challenge funds provide additionality by offering a risk-sharing mechanism to innovative business ideas that would otherwise be deemed too risky to access financial support from investors.

In contrast to other sources of grant funding, challenge funds use competition to solicit a variety of inventive and bold private-sector solutions to development challenges. Competitions should be broadly marketed, with clear rationale, eligibility and selection criteria in order to generate a large bank of qualified applicants.

The process of selecting winners varies among challenge fund competitions, but often depends on a number of factors including capacity for commercial success, degree of innovation, level of risk, geographic relevance, potential for systemic change and large-scale positive impact. To disrupt the status quo and bring about systemic change, challenge fund managers seek businesses that have highly capable management teams, innovative ideas and potential to scale up. By requiring grantees to match funding and share the risk, challenge funds ensure that selected companies are financially invested in their own success and in achieving their commitments to bringing about positive social impact. They also look for companies that engage with poor communities at the core of their business models – this can lessen the conflict between the pursuit of social and commercial returns down the line.

Another main feature of challenge funds is their focus on creating additionality, which is achieved through risk sharing. Sharing costs enables cutting-edge projects, which otherwise would be too risky to garner private funding, to develop and mature. Risk sharing also ensures that grants do not distort local markets by displacing or competing with available commercial capital.

What are the design options?

There are many factors to consider when designing an ECF. The following is a list of features that all challenge funds share, despite their variations.

General

Objective

[6] Rakabe, E. 2012. The Jobs Fund and a Youth Wage Subsidy: Design and Implementation Issues. Econ 3x3. http://www.econ3x3.org/article/jobs-fund-and-youth-wage-subsidy-design-and-implementation-issues#sthash.k8S6rNa9.dpuf

ECFs should be open and transparent in their rationale and objectives. Vague financing objectives can result in poorly managed funds, weak project selection and wasteful spending. Thus, the reason for establishing an ECF should stem from a comprehensive and clear understanding of a particular gap in the market. Significant research and local knowledge should inform the objective of the challenge fund in order to identify critical value chain gaps and innovative, competent solutions.

Governance

Designing a governance structure is crucial for successful implementation of a challenge fund. Fund managers and donors are advised to clearly define roles and responsibilities of key stakeholders, as well as the level of influence donors will have on selection and implementation of projects, prior to making any important decisions.

Structure

Targeted focus

The objective of each challenge fund determines the depth and breadth of the targeted focus. Challenge funds may vary by their targeted sector, location in the value chain and population. ECFs, which have a narrow focus, can make the process of comparing applicants easier by creating more defined selection criteria; however, they also run the risk of garnering fewer qualified applications.[7]

Geographic focus

Depending on the focus and objective of the fund, competitions may be targeted to local, national, regional or global pools of applicants. Limiting the competition to a smaller geographic scope reduces management costs and may increase the potential for impact, but risks a poor return of quality applications.[8] Because they have a narrower focus than social and civil society challenge funds, ECFs are more likely to be implemented at the regional and national levels than globally.[9]

Number of windows

Determining the number of windows and their openings is very important in terms of how many high-quality applications will be received. Challenge funds with a narrow focus (e.g. on a specific issue in a particular sector of one country or region) should limit the number of application openings to one to two times per year. Having more than one to two openings may result in a low return on high-quality project submissions. For larger challenge funds such as the African Funding Innovation for Business in Africa (AECF), which have a broader purpose and geographical coverage, offering several competition windows allows the fund to tailor funding to more specific targets.[10]

Technical assistance

Successful challenge funds provide a high level of technical assistance to businesses during the proposal and business plan development stages so that there will not be the need for technical assistance during project implementation. Within the challenge fund community of experts, there have been several recent discussions about whether applying a more 'hands-on' approach achieves greater success and overall impact. ECF purists argue that rather than risking external market distortion, donors and fund managers should maintain a 'light-touch' role, linking projects to appropriate technical assistance providers.[11]

Marketing

A targeted and clear marketing strategy is essential for ensuring a competent pipeline of candidates. Although marketing competitions broadly has been advised in the past, recent ECF assessments

[7] http://www.sida.se/contentassets/3aa2456211934e8dac038ea55fcddccd/guidelines---challenge-funds_3466.pdf
[8] http://www.sida.se/contentassets/3aa2456211934e8dac038ea55fcddccd/guidelines---challenge-funds_3466.pdf
[9] O'Riordan, A., Copestake, J., Seibold, J. & Smith, D. 2013. Challenge Funds in International Development. http://www.tripleline.com/wp-content/uploads/2013/12/Challenge-Funds-in-International-Development.pdf
[10] http://www.sida.se/contentassets/3aa2456211934e8dac038ea55fcddccd/guidelines---challenge-funds_3466.pdf
[11] https://www.linkedin.com/groups/3728319/3728319-6032543897077510147

support a more targeted approach.[12] Such an approach could include marketing the competition directly to relevant companies or specific individuals within the companies. The logic supporting this proactive marketing strategy is that a targeted approach reduces administrative costs incurred from evaluating applications and elicits a more sophisticated pool of candidates.

Monitoring and evaluation

Monitoring systems should be designed in advance, with clear division of responsibilities and cost-bearing mechanisms. Monitoring, reporting and evaluation are necessary to ensure that commitments are being achieved, investments are applied correctly and impact is measured to inform best practices. Evaluations of challenge fund projects must assess: the projects' relevance to the fund's objectives; their impact and effectiveness; the cost-effectiveness of financial investments from both sides; and the projects' sustainability and potential for scale.[13]

Defining impact measurement

In addition to designing monitoring and evaluation plans, measuring change and defining meaningful indicators of systemic impact are crucial steps for ECFs – not only to justify their funding, but to learn from experiences and share these lessons with others to improve their performance.

The Donor Committee for Enterprise Development (DCED) has developed the following guidelines for measuring systemic impact:[14]

> *Plan for long-term monitoring*: The time needed to observe systemic change varies depending on the type of fund. Early signs of change might include government officials drafting new legislation, showing increased openness to discussion or inviting more businesses to comment on proposed changes.
>
> *Consult the businesses, but do not ask them to measure systemic change*: Discuss systemic change with grantees, using accessible language.
>
> *Take an investigative approach*: The fund manager must adopt a flexible approach to measurement, which requires a certain amount of detective work to establish what has changed in the market system following the intervention.
>
> *Interview different stakeholders*: Speak with multiple informants to triangulate information and better understand the market system.
>
> *Use qualitative information*: Numbers do not tell the full story. Qualitative information helps to demonstrate change.
>
> *Consider attribution*: Systemic change is always the result of multiple factors and it is necessary to show that the challenge fund contributed to the observed change.

Eligibility criteria

Type of grants

The design committee must decide whether selected projects will be in the planning stage or will be demonstrating a project that has already been developed.

Type of businesses

Depending on donors' intentions, ECFs may limit their eligibility criteria to small and medium-sized enterprises or initiatives of large national or multinational corporations, or leave eligibility open to all types of businesses. Multinational corporations and large national companies may have innovative

[12] Davies, R. and Elgar, K. 2014. Enterprise Challenge Funds for Development: Rationales, Objectives, Approaches. Australian National University

[13] O'Riordan, A., Copestake, J., Seibold, J. & Smith, D. 2013. Challenge Funds in International Development. http://www.tripleline.com/wp-content/uploads/2013/12/Challenge-Funds-in-International-Development.pdf

[14] Kessler, A. 2013. Measuring Results in Challenge Funds: Practical Guidelines for Implementing the DCED Standard. DCED.

solutions that might only by implemented or catalyzed if additional funding is available. M-Pesa, an initiative of Vodafone and the largest provider of mobile banking services in Africa, is one example of an innovative solution that was catalyzed through the UK Department of International Development (DFID) Financial Deepening Challenge Fund (FDCF).[15]

Stage of business development

Eligibility criteria commonly require applicants to prove they have been in existence for a minimum of two or three years, never filed for bankruptcy or been under investigation for fraud or corruption.[16] The rationale behind only accepting projects with two to three years of history is to ensure that they are not in need of major start-up assistance, are likely to achieve their commitments during the implementation period and have a high potential for sustainability and scale following the challenge fund's financial assistance.

Financial

Management costs

ECFs' management costs have been considered very high compared to other funding mechanisms. Typically, management costs average about 20 percent of the total budget per year.[17] However, over a longer period of time, the ratio of management costs to project investments can climb to as high as 50 percent (e.g. PriceWaterhouseCoopers' management fee for the Innovations Against Poverty Challenge Fund)[18] depending on the services provided, such as technical assistance and fund-manager monitoring and evaluation.

Size of grants

Selecting the maximum and minimum size of available grants depends on total financial capacity, including management costs. These amounts will also determine the size, level of development and scope of the competition applications. Larger grants often exclude small and medium-size enterprises due to their difficulty in matching the funding. On the other hand, a minimum amount is also important to ensure that the transaction and processing costs do not make up a majority of the grant total.[19] ECFs typically range from US$20,000 to US$ 50 million.[20]

Grant matching

Thus far, ECFs have typically employed a pre-decided cost-sharing ratio for the selected projects. However, recent discussions such as the BEAM Exchange LinkedIn discussion in September 2015 have criticized this approach. James Blewett, Practice Leader of Economic Policy and Strategy at Maxwell Stamp, argues that, "a much better methodology is to offer variable grants based on the price the super-risk associated with the location and nature of the investment in the context of the size of the initial investment and the expected returns." Blewett claims that this approach will allow fund managers to rationalize the amount of grant required to tip the balance in the desired investment decision-making process, and to increase the clarity and quality of financial planning in the investment decision.[21]

Grants or loans

All challenge funds offer grants to selected projects; however recently some challenge funds such as the AECF have been exploring the option of offering loans as well. While this option does free up funding,

[15] http://www.proudlymadeinafrica.org/images/uploads/docs/M-Pesa_CaseStudy_June14_synopsis.pdf
[16] http://www.sida.se/contentassets/3aa2456211934e8dac038ea55fcddccd/guidelines---challenge-funds_3466.pdf
[17] Interview with Timothy Hobden, former Senior Technical Advisor to the Jobs Fund of South Africa, March 22, 2016.
[18] http://www.sida.se/contentassets/3aa2456211934e8dac038ea55fcddccd/guidelines---challenge-funds_3466.pdf
[19] http://www.sida.se/contentassets/3aa2456211934e8dac038ea55fcddccd/guidelines---challenge-funds_3466.pdf
[20] Interview with Timothy Hobden, former Senior Technical Advisor to the Jobs Fund of South Africa, March 22, 2016.
[21] https://www.linkedin.com/groups/3728319/3728319-6032543897077510147

allowing donors to invest in more projects, it is a controversial solution since even successful projects struggle with cash-flow issues in their early years of development and scaling up.[22]

What are success factors and prerequisites for implementing the instrument?

Successful enterprise challenge funds typically exhibit the following qualities:

Clearly defined, explicit rationale and acute awareness of the problem and market
One of the key principles in designing a challenge fund is to research and understand the market gaps that can be supported by funding from challenge funds. ECFs that invest time and resources to obtain local knowledge and experience with development and the business ecosystem before establishing the fund are typically better situated for successful marketing and selecting viable business ideas than ECFs with more general objectives.

Strong, clearly defined governance structure

The roles and expectations of actors need to be clearly defined to avoid conflict within the governance structure. The investment committee should have the executive and fiduciary responsibility for the approval of funding applications, and should remain independent of the fund manager.

Theory of change

ECFs are advised to work with a clear theory of change, which guides all strategic decisions of the programme.

Effective marketing and branding to gain attention and attract the best business ideas
Measures should be taken to identify beneficiaries (including countries and small-scale producers), and therefore ensure adequate and targeted resource allocation.

Effective monitoring and evaluation

Evaluation is crucial to measure impacts and to tackle weaknesses. The longer an ECF instrument is in place, the more complex the financing structures become. Thorough evaluation and integration of lessons learned can be applied to refine mechanisms that reduce weaknesses, improve targeting of beneficiaries and enhance resource acquisition.

Assistance in finding additional funding to match grant

ECFs that provide grantees with links to impact investors, private investors and other sources for matching grants have the potential to draw in more innovative ideas; otherwise, grantees would struggle to share the costs, limiting their innovation. In addition, linkages that leverage additional private investments increase donors' interest in challenge funds.

Hands-on role of fund managers

Although challenge funds are intended to be administered with only a light touch, some of the more successful examples include active monitoring, technical advice and business development services to increase their chances of success. Managers that connect companies implementing selected projects with similar businesses can accelerate scalability.

Larger projects with greater implementation capacity tend to offer more potential for systemic impact

[22] AECF. 2015. African Funding Innovation for Business in Africa: Impact Report 2014. http://www.aecfafrica.org/downloads/AECF-2014-Impact-Report.pdf

The argument for supporting large and multinational companies is that they have a better structure and capacity to bring about systemic impact, and a greater voice to enter into public-private dialogues. Challenge funds generally are not suitable for start-up businesses since they require bidders to contribute substantially to the costs of the project.

Expectations of the fund manager and businesses should be clearly defined and strictly implemented

Businesses should concentrate on delivering the commercial objectives of the project while the fund manager should concentrate on ensuring that the fund's social objectives are significant and measurable.

Cooperation with external efforts to avoid duplication

When a fund is part of a larger organization, synergies should be used to share knowledge and avoid duplication of efforts. Furthermore, funds can follow complimentary agendas to follow an integrated strategy for environmental, economic and social outcomes.

Case studies

Case 1: African Enterprise Challenge Fund (AECF)

Background

The AECF was launched in 2008 with the objective of contributing to the growth of sub-Saharan Africa's agricultural, agribusiness and renewable energy sectors, resulting in sustainable benefits for rural poor people.

The AECF is managed on a daily basis by KPMG International Development Advisory Services and funded by several donors, including UKAid (the largest contributor), the Australian Department of Foreign Affairs and Trade, Sida, Danida, the Kingdom of the Netherlands, the International Fund for Agricultural Development (IFAD) and C-Gap. Each donor has a focus area or geographical region that it wishes to impact, and the AECF provides the means to target those focus areas and regions, and to award grants and monitor and evaluate their performance.[23]

In order to effectively identify the most innovative projects in specific sectors and regions, the AECF fund manager has launched a series of targeted competitions requiring potential grantees to submit their ideas and business plans. The fund offers several windows – including both continent-wide and national/regional competitions – depending on the strategic design. 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 eligibility criteria.[24]

The AECF is the only challenge fund to have ventured into offering loans as part of its portfolio. This feature has been met with mixed reviews. The benefit of including loans and repayable financing is that if gives donors more financial flexibility. However, the 2014 review of the AECF mentions that the fund manager does not wish to continue with loans since businesses that are growing generally still face cash-flow challenges.[25]

Results

From AECF's inception in 2008 until the end of 2014, US$244 million was allocated to the fund by its donors, with US$144 million committed to 208 projects across 23 countries. Through a grant-matching

[23] http://www.aecfafrica.org/about-aecf/stakeholders
[24] AECF. 2015. African Funding Innovation for Business in Africa: Impact Report 2014. http://www.aecfafrica.org/downloads/AECF-2014-Impact-Report.pdf
[25] *Ibid.*

mechanism, the AECF was able to leverage another US$401 million from selected projects. This represents a leverage ratio of 2.79 on committed matched funding.

By the end of 2014, the AECF had:[26]

- reached an estimated 1.39 million households – equivalent to 7 million people;
- funded projects generating the equivalent of US$117 million in benefit for poor households; and
- helped to create over 5,000 jobs in supported businesses and improved access to clean, sustainable energy for over 200,000 families.

Case 2: Jobs Fund (South Africa)

Background

South Africa's Jobs Fund is the first and largest government-run ECF. The objective of the Jobs Fund is to co-finance initiatives that will contribute to job creation in South Africa. In particular, the Jobs Fund aims to facilitate new and innovative methods of increasing employment participation in the economy. Rather than duplicating efforts or competing with other solutions, the Jobs Fund intends to complement existing initiatives that work to reform the long-term, structural causes of slow growth and unemployment in South Africa.

In 2011, the Ministry of Finance launched the Jobs Fund, which was then established and managed by the Development Bank of Southern Africa (DBSA).[27] DBSA was designed with the intention of creating jobs through innovative business solutions. In partnership with stakeholders from across the economic spectrum in South Africa, DSBA aimed to support good ideas, new approaches and initiatives that enhance the ability of the economy to create and sustain new jobs. The fund targets initiatives aimed at assisting long-term unemployed youth and women. It is financed with a public investment of R 9 billion for three years of implementation.[28]

With public funding, the Jobs Fund co-finances projects from public, private and non-governmental organizations that aim to significantly contribute to job creation. Project partners are required to match the grant fund allocation either on a 1:1 ratio for private-sector partners or 1:0.2 for non-private-sector partners. The competition is administered through the following four funding windows:[29]

- *Enterprise Development* – targets initiatives that leverage existing private-sector capacity, experience and resources to facilitate job creation.
- *Infrastructure Development* – targets light infrastructure investments that will unlock investment and activity linked to additional job creation.
- *Support for Work Seekers* – targets innovative approaches to training and job placement, which enable employment for unemployed work seekers.
- *Institutional Capacity Building* – targets institutional strengthening and capacity building of entities that underpin the effective operation of South Africa's labour market and employment facilitation entities.

Role in national policy

The Jobs Fund is part of South Africa's Active Labor Market Policy (ALMP), a term used to describe a broad range of policies aimed at increasing productivity, reducing structural imbalances in the economy and improving the national labour market by assisting unemployed work-age citizens in finding jobs. ALMPs face many potential unintended consequences, such as substitution and displacement of the natural labour market and becoming deadweight (i.e. not achieving any additionality).

[26] *Ibid.*
[27] http://led.co.za/led-programme/jobs-fund
[28] Jobs Fund. The Jobs Fund – What it Aims to Achieve and Who Should apply?
[29] http://led.co.za/sites/default/files/jobs_fund2.pdf

Due to the variability among ALMPs, their effectiveness must be determined on a case-by-case basis, taking into account the many external factors that influence their success. However, a few key features have been identified as contributing to the success of ALMPs, including targeting an appropriate and defined group of participants, and designing a well-defined programme with specified timeframes, geographical and sectoral focuses.

Assessments of national-level ALMP programmes that do not target any specific group or sector, such as the Jobs Fund, indicate that they typically achieve less in terms of impact than those that are small scale or locally run.[30] Furthermore, the Jobs Fund is susceptible to high deadweight losses since the outcomes may not substantially differ from what would have occurred in their absence (e.g. hiring educated people who would likely find jobs without the programme). Although these trends do not necessarily suggest that programmes such as the Jobs Fund will indeed become deadweight, it is important for the designers to be conscious of potential consequences and align strategies with programmes and tactics that have been deemed successful.

Results

Following a 2014 review of the first three years of the Jobs Fund implementation, the following impacts were measured:[31]

- The total number of approved projects stands at 93, with a total grant value of R 4.96 billion. With leveraged funds from project partners, the total value of job creation projects approved by the Jobs Fund now stands at R 6.1 billion.
- The current approved portfolio targets the creation of 143,914 new, permanent jobs over the next five years. These are jobs that would not have existed without the Jobs Fund's intervention. In addition, approved projects are expected to place 55,989 individuals into existing vacant jobs by providing training and placement services.
- As of December 2013, 51 projects were being implemented. The Jobs Fund has disbursed R 802 million in grant funding to these projects, which has leveraged an additional R 697 million from project partners.
- Over this period, projects supported by the Jobs Fund created 12,184 permanent new jobs, of which 50 percent were for young people, and 9,728 placements in existing jobs.
- These projects have created 5,443 short-term jobs and have provided work-readiness training to 39,594 individuals. The Jobs Fund has a specific focus on addressing youth unemployment, with 97 percent of job placements and 70 percent of internships having youth beneficiaries.

Case 3: Afghanistan Business Innovation Fund (ABIF)

Background

The Afghanistan Business Innovation Fund (ABIF) is a three-year programme that ran from September 2011 to August 2014. ABIF operated as an ECF supporting private-sector investments in innovative and commercially viable products or services that benefit poor men and women as producers, workers and consumers. Its total budget was £7.2 million, of which DFID contributed £6 million and AusAID contributed £1.2 million.

The ABIF included a number of focus sectors in which market analysis identified major obstacles to inclusive growth, including horticulture, livestock, carpets, furniture, healthcare, mining and household services.[32]

[30] Rakabe, E. 2012. The Jobs Fund and a Youth Wage Subsidy: Design and Implementation Issues. Econ 3x3: http://www.econ3x3.org/article/jobs-fund-and-youth-wage-subsidy-design-and-implementation-issues#sthash.k8S6rNa9.dpuf
[31] http://www.treasury.gov.za/documents/national%20budget/2014/Jobs%20fund.pdf
[32] http://media.wix.com/ugd//0c245d_205e7b3a589738dfcc81a58eb82f524f.pdf

The fund developed a unique methodology for evaluating applications and allocating grants. All applications passed through a sequential evaluation process, which allowed it to select the portfolio of investment projects that would maximize the expected development outcome within the grant budget for each round. The amount of the grant was calculated in relation to the specific risks and returns of each project. Ultimately, the higher the expected development outcome and the lower the amount of the grant that the applicant requested, the more competitive the grant application would be.[33]

Results

Upon review of the ABIF's first round, it became apparent that a more purist facilitative approach would have achieved very little with the same budget in the same timeframe. Although the fund managers would have preferred not to intervene in the implementation process, the entrepreneurs and investors with whom they worked found the level of engagement to be insufficient.

At mid-term, the agreed-upon indicator had substantially not been met. This failure to reach the milestones was largely because they were unrealistic given the time required to administer bids, select grantees and disburse funds, then develop products and services. In Round 1, 350 concept notes were received in response to the call, from which seven projects were selected by the ABIF investment panel, including initiatives such as a branded pharmacy chain to combat counterfeit pharmaceuticals. Following due diligence processes, DFID signed off on seven grants in July 2012 totaling £1,627,398, after which implementation agreements were signed and initial funds disbursed. Round 2 was significantly delayed for a number of reasons beyond the direct control of the implementing partner. The mid-term evaluation highlighted the fact that more time was required for grantees to bring their products and services to market. In addition, there was a need for more frequent monitoring and reviews, and better revision.

Following completion of the three-year programme, the following impacts was measured:[34]

- DFID supported 21 ABIF grantees through two rounds, of which 13 successfully achieved their milestones, with all but three expected to complete them by the end of 2015.
- Ten grantees applied and were approved for post-grant support. This funding window was intended to: (i) support the scale-up of current operations to increase business impact; and (ii) increase the businesses technical or administrative capacity, with the overall goal of the business completing their investment projects and ultimately becoming more competitive in their work toward inclusive market development.
- One of the grantees, Al Hadi Ltd, established Afghanistan's first retail pharmacy chain (including 786 pharmacies), which sells high-quality imported medicines as well as general healthcare products, and has growing brand recognition in Kabul. In addition, Sanaizada Edible Oil has completed the final phase of its business expansion plan by installing an innovative packaging unit that can make recyclable PET bottles for its oil.

Case 4: Responsible and Accountable Garment Sector Challenge Fund (RAGS)

Background

As a pioneer of challenge funds, DFID has designed and implemented many competitions since the 1990s, including the Responsible and Accountable Garment Sector Challenge Fund (RAGS). RAGS was designed to support projects with the objective of improving the working conditions and livelihoods of vulnerable employees in the garment industry. From 2010 to 2013, the managing body of RAGS, Maxwell Stamp Public Limited Company, implemented a competitive grant that provided matching funds to 12 winning projects in the sustainable garment sector in India, Bangladesh, Nepal and Lesotho. DFID provided a total of £2.853 million to these projects, all of which aimed to improve labour conditions and

[33] http://www.imurabba.org/
[34] http://www.acbar.org/files/downloads/ABIF%20Evaluation%20ToRs%20-%20Final.docx.

use responsible and ethical methods of production.[35]

Evidence of impact

With RAGS, DFID and its partners hoped to identify and develop projects with sustainable, ethical and replicable solutions to garment-production challenges in developing countries. After three years, the RAGS programme was evaluated according to project-specific measurements as well as the following International Labour Organization Decent Work 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 country of intervention);
- Percentage of workers receiving overtime due to them;
- Percentage of workers working more than 60 hours per week; and
- Percentage of workplaces audited showing incidence of child labour. [36]

Case 5: The Malawi Innovation Challenge Fund (MICF)

Background

The Malawi Innovation Challenge Fund (MICF), part of UNDP's Private Sector Development Project (2013-2016), has taken an innovative approach to facilitating the private sector in Malawi to innovate and find profitable ways of improving market access for poor people. The MICF focuses on stimulating innovation in the agricultural sector and deepening the manufacturing sector to support the country's economic transformation from an over-reliance on imports and consumption to one that prioritizes exports and production. The instrument is a clear response to the Government's National Export Strategy – a roadmap for building Malawi`s productive base in order to generate sufficient exports to match the upward pressure on Malawi`s imports.

The MICF is the latest in the new generation of challenge funds launched over the past two years that builds on lessons learned from earlier funds and is one of the very few single-country focused challenge funds.

DFID entrusted UNDP with US$8 Million for the MICF's first round of competition, which was launched in April 2014 for the agriculture and manufacturing windows. KfW Development Bank provided EUR 3 million for a new challenge window on manufacturing and logistics, launched in July 2016. IFAD provided an additional US$2.5 million for a challenge window on irrigation to be launched towards the end of 2016. More development partners are intrigued by this instrument and negotiations are underway for further challenges to open in the course of 2017.

Evidence of impact

The first round of competition for the agriculture and manufacturing windows, launched in April 2014, contracted ten grantees with approximately US$5.5 million. Projects are currently in the implementation phase with an end date set for July 2017. Agricultural window projects aim to increase the incomes of over 11,800 poor households and create an estimated 290 full-time jobs for poor people. The manufacturing window's projects aim to increase the incomes of over 21,900 poor households, create an estimated 900 full-time jobs for poor people and provide low-cost products to 30,000 poor consumers.

Over the past year, the MICF has begun to demonstrate that there is a resilient and emerging private sector in Malawi with capacity to innovate and evolve despite the country's challenging economic environment. The MICF has been able to identify pioneer firms that have embraced the need for better

[35] http://www.oecd.org/derec/unitedkingdom/Evaluation-Responsible-Accountable-Garment-Sector.pdf
[36] http://www.sida.se/contentassets/3aa2456211934e8dac038ea55fcddccd/guidelines---challenge-funds_3466.pdf

integration with the poor people – either as producers in their supply chains or as new customers that need to be served by better and lower-cost products and services.

Implementation

What results have been achieved with this instrument?

Careful deployment of financial support to key market players can be an excellent way of accelerating, expanding or deepening change in market systems.[37]

Recent evaluations demonstrate positive results overall from challenge fund investments, with most achieving their goals. There is less evidence of systemic development impact beyond the micro level – the extent to which funded projects create structural changes that impact poverty. Nonetheless, some of the key lessons learned and best practices from challenge funds include the following:

Market development

Challenge funds specifically look for the most innovative and sustainable models to develop and reach scale. Once the business has reached a large enough size, there are three ways in which the project can impact the market: replication of the business model, crowding in and replicating successful practices.

Political leverage

By engaging with local, regional and national governments, some ECFs and their projects have been successful in generating positive change in political, legal and regulatory environments. For example, projects financed by the AECF have influenced policymakers in Kenya to introduce a 0 percent VAT charge on solar products. In Zimbabwe, the AECF is credited with the establishment of regulations around weather index insurance satellite data and the introduction of a new micro-finance bill.[38]

Stimulating large amounts of private funding

One of the main advantages of ECFs is their ability to stimulate interest from private investors by sharing risk and legitimizing a risky business idea through donor support. The leverage ratio for private funding organized by ECF-supported projects can range from 1.1 to 2.8. For example, in the most recent review of the AECF, the leverage ratio on matched funding over a six-year period reached 2.79, bringing in private investments totaling US$401 million.[39]

Significant positive impact on low-income households

AECF is credited with supporting private-sector projects that directly improve the livelihoods of 1.39 million households in Africa by creating jobs and making products more accessible and affordable for low-income consumers.[40]

What unintended side effects must be taken into account?

[37] Beam Exchange LinkedIn Discussion. 2015. Using Challenge Funds as a Market Development Instrument.
[38] AECF. 2015. African Funding Innovation for Business in Africa: Impact Report 2014. http://www.aecfafrica.org/downloads/AECF-2014-Impact-Report.pdf
[39] *Ibid.*
[40] *Ibid.*

ECFs are designed to be a minimally invasive mechanism for public funds to support private-sector development without creating market distortion or negatively impacting the local ecosystem. However there are times when ECFs are not implemented carefully and can contribute to unintended side effects.

- Challenge funds on their own can be a great solution to localized issues; however when applied on a larger scale, there is little evidence to support systemic impact. The recent trend is to embed challenge funds in 'markets for the poor' programmes, where they are a part of a larger private-sector development solution.[41]
- Ideas that do not have capacity for proper monitoring and evaluation can result in wasted funds.
- Often, companies take out loans to match funding and risk bankruptcy if success is not achieved.
- Too much influence from donors and fund managers can cause external market distortion.
- 'Light touch' strategies have a higher chance of failure – many companies also need technical and business development assistance.
- There is no shortcut to development. It is important to focus on incremental solutions rather than trying to do too much with too few resources.
- Political interference in unstable nations has the potential to be positive or negative.
- An inability to engage in business development may limit the ability to test the most innovative ideas or dig deeper into emerging markets. Companies in emerging markets often fall short on business fundamentals: they may lack experienced management teams, understanding of sound corporate governance and rigorous financial systems.

What are the barriers and risks?

Implemented well, enterprise challenge funds can be relatively easy and low-risk tools to facilitate private-sector growth, market innovation and sustainability. Since the concept is comparatively new and assessments lack conclusive findings on systemic impact (either negative or positive), the risks associated with challenge funds are not yet evident. Still, evaluations have identified several risks stemming from weaknesses in design and implementation procedures. Stakeholders should assess their fund's exposure to the following risks and challenges, and identify clear steps to avoid them.

Insufficient high-quality proposals

Competitions that have a very specific or narrow focus, or a weak marketing campaign may risk limiting their pool of candidates to an insufficient number, or eliciting low-quality proposals. Comprehensive market research and assessment of potential partners must be carried out to attract relevant and competent submissions.

Lack of innovative proposals

Establishing challenge funds in overdeveloped or underdeveloped markets runs the risk of attracting similar projects or recycling old solutions. Prior market research and local knowledge should be used to guide eligibility and selection criteria in order to ensure that only relevant, innovative and commercially viable enterprises apply for grants.

Lack of private-sector interest

Without a strong marketing strategy or a high-profile launch of the competition, ECFs may not be able to elicit a strong level of interest or proposal submission from the private sector. Targeted marketing and regular engagement with relevant networks can prevent this from occurring.

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[41] BEAM Exchange Discussion: https://www.linkedin.com/groups/3728319/3728319-6032543897077510147

Projects funded are not sustainable

During the selection process, projects that have a greater potential for self-sustainability and financial growth after the duration of the programme should receive higher priority. Priority should also be given to projects with a results-based approach.

Lack of business development skills, awareness and knowledge

Many small- and medium-sized businesses in developing countries lack sufficient business development and technical skills to design solid business plans and implement informed and decisive actions. Although ideas may be innovative and have high potential for success, projects may fail due to a lack of proper knowledge and awareness of how to run a business. Fund managers can mitigate this risk by selecting candidates that have the capacity and management structure to develop a solid business foundation.

Fund management is unsatisfactory

Timely implementation of procedures and financial management, as well as strong compliance are essential to the success of the selected projects. Donors and fund managers should ensure reliability and accountability by establishing a clear set of expectations, terms of reference and performance goals, and by selecting projects that have expressed clear goals.

Fraud

Fund managers should provide explicit rules for acceptable uses of funds, and ensure reliable controls and regular supervision.

Inadequate monitoring and evaluation

Poorly designed and implemented monitoring and reporting systems can lead to wasteful spending and inefficient development of projects. To ensure consistent development and proactive responses to challenges, it is crucial to have a reliable schedule of regular reporting on projects, and timely submission of evaluations and assessments from fund managers.

Who are critical stakeholders for implementation and what are their roles?

ECFs aim to create new partnerships between the private and the public sectors to reach development goals. The intended roles in this partnership are clear: the government partner provides risk-willing funding that is otherwise not available and guarantees a rule-based and transparent bidding process, while the private partner offers innovative ideas to solve a development problem and ensures its professional implementation. Unlike in development partnerships, the public partner does not get involved in project implementation.

A more detailed list of stakeholders might include the following:

Policy makers can either be situated in countries or institutions contributing financial resources to the fund. In this case, their role is funding, and through the standing they have by providing financial resources, they can channel their agendas and concerns through the fund. This gives them a say in where, how and why the money is spent. Policy makers can also be included in the funding institution as managers or overseers, and set specific targets and strategies since they have intimate knowledge of what can be improved.

Public-sector donors supply risk-willing funding where it is otherwise not available and should not be involved in implementation of selected projects.

Fund managers are responsible for the daily implementation of challenge funds and ensure representation of donor interests.

Businesses offer innovative solutions to development problems and ensure professional implementation.

Low-income communities are involved as beneficiaries in funds that specifically aim to bring about a pro-poor impact. Low-income individuals are also often included as employees or producers of selected projects.

Third-party finance organizations help with grant matching when businesses cannot provide their own funding. Typically, fund managers prefer to avoid projects financed by third-party organizations because their vested interest is not as significant as it is with businesses' own cash or in-kind funding.

Third-party evaluators are often used in cases when the fund requires – but does not offer support in – reporting and evaluating business and impact data.

NGOs and consulting organizations can be included to provide technical, financial or business-development support to businesses or perform impact assessments and evaluations of challenge fund programmes.

What could a process to implement the instrument look like?

Setting up an ECF

- Define roles of the governing body, donors, fund managers and investment committees.
- Identify the objective and theory of change.
- Define eligibility criteria, including the geographical focus, target companies and stage of business development.
- Define selection criteria: the process for selecting challenge fund winners should always be very transparent.
- Cost structure: from the total budget allocated by the donors, determine the shares of management costs, administrative costs and available grant funding.
- Clarify details, including fund duration, number of competition windows, application process and level of technical assistance available.
- Design and share application forms or the online portal.
- Decide upon a marketing strategy and campaign.
- The investment committee meets to select grant winners.
- Determine reporting, monitoring and evaluation procedures.
- Put in place procedures to avoid corruption and malpractice.

Implementing an ECF

- Agree upon risk-bearing and cost-sharing plan, and a schedule of financial dispersal for grantees.
- Agree on a regular reporting and monitoring, and site-visit schedule.
- Evaluate business development and potential for success, or hire an independent third-party evaluator to perform the assessment and produce a report.
- Assess the fund's overall contribution to systemic change and social impact.

Ideas for further research and knowledge gaps

- How can challenge funds be designed to incentivize impact and sustainability?
- Should challenge funds have a technical support component?
- How can the additionality of challenge funds be evaluated with limited resources?

- Do challenge funds have enough systemic impact to be used independently or is it better to embed them in larger development programmes?
- How can challenge funds be designed to reduce the urge to fund less risky projects?
- Has there been any systemic impact attributed solely to ECFs?

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