Report

Understanding challenge funds

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- Challenge funds aim to mitigate against risk in markets where business innovation can contribute to poverty alleviation
- Challenge funds need to be widely promoted, and have clear eligibility and selection criteria to elicit large numbers of applicants
- The 'challenge' is best addressed by the private sector for which viable solutions are not available due to perceived risk

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Abbreviations

ADB	Asian Development Bank
AECF	Africa Enterprise Challenge Fund
AusAID	Australian Agency for International Development
BLCF	Business Linkages Challenge Fund
CEF	Child Education Fund
CGAP	Consultative Group to Assist the Poor
CIDA	Canadian International Development Agency
DfID	Department for International Development
ECF	Enterprise Challenge Fund
EICF	Enterprise Innovation Challenge Fund
FDCF	Financial Deepening Challenge Fund
FEF	Financial Education Fund
GEC	Girls Education Challenge Fund
IADB	Inter-American Development Bank
IAP	Innovation against Poverty
NGO	Non-Governmental Organisation
ODA	Overseas Development Assistance
PPIC	Pro-Poor Innovation Challenge
SCF	Sawaed Challenge Fund
SIDA	Swedish International Development Agency
SME	Small and Medium Enterprises

TLCF	Technology Literacy Challenge Fund
USAID	United States Agency for International Development
VBCF	Vietnam Business Challenge Fund

1 Introduction

AusAID Indonesia is currently designing the 'Supporting Indonesia's Tertiary Education' project. The project builds on the lessons learned from a two-year programme of demand-driven analysis and policy engagement with the Directorate General of Higher Education, as well as independent and multi-donor analysis. It aims to help Indonesia improve the quality of tertiary education, the quality of research produced by tertiary education institutions, and disadvantaged students' access to, and performance in the sector. To achieve this, AusAID will establish a competitive funding scheme aimed at channelling grants to selected institutions. Once funding has been approved, AusAID will attempt to identify common, grant-related problems and solicit solutions through a challenge fund mechanism, which will invite the private sector to submit alternative proposals to address these issues. This research on challenge funds seeks to inform the project-design process and provide the evidence base needed for a clearer understanding of how challenge funds work, and might be applied, within the education sector.

The research paper will answer the following questions:

- How are challenge funds structured and how do they work?
- What are the costs associated with the creation and administration of funds?
- What are the risks related to challenge funds and how can they be overcome?
- What evidence exists for the effectiveness of challenge funds and similar funding mechanisms?
- What conditions are required for a successful challenge fund?
- What lessons and best practice can be applied when establishing challenge funds?

2 Methodology

This section provides an overview of the methodology used to identify the relevant research literature.

Literature review: The desk review included all academic literature, research and technical papers, government reports and working papers relevant to the research questions.

Academic literature was the main source of information about challenge funds and their structural design. A certain amount of 'grey' literature was located through consultation with researchers and service providers, who identified sources outside the scholarly databases. More general searches were made using Google Scholar. Searches were limited to research in English.

Key criteria were used for including or excluding articles from the literature review. We reviewed the abstract (or entire document if there were no abstract) to determine whether the content met the inclusion criteria. The following describes the inclusion/exclusion criteria.

Inclusion criteria: Documents that discussed challenge funds, their design and impact/evaluation assessments.

Exclusion criteria: Documents about challenge funds whose content was not relevant to the main research questions. No documents were excluded based on date of publication.

When an abstract was identified as relevant to the criteria, the full article was accessed. Articles were first skimmed, before making further selection based on relevance to the research questions.

After the literature review, we contacted 15 experts with professional experience in challenge funds, and interviewed fund managers from the Africa Enterprise Challenge Fund, the Vietnam Business Challenge Fund and the Girls Education Challenge Fund. Questions were based on gaps identified in the literature review, while others addressed lessons learned.

3 Challenge funds

3.1 What are challenge funds?

Challenge funds are seen as an innovative and versatile financing mechanism for channelling public funds for development. A definition shared by the UK's Department for International Development (DfID), the Inter-American Development Bank (IADB) and the Canadian International Development Agency (CIDA) describes them as 'a competitive mechanism to allocate financial support to innovative projects, to improve market outcomes with social returns that are higher/more assured than private benefits, but with the potential for commercial viability'. The Swedish International Development Cooperation Agency (SIDA) defines a challenge fund as 'a financing mechanism to allocate (donor) funds for specific purposes using competition among organisations as the lead principle'.

As Irwin and Porteous (2005) observe: 'In practice, the objective of a challenge fund is to provide the smallest possible financial contribution to a socially worthwhile project consistent with making it less risky and more financially sustainable to the private promoter.'

3.1.1 Historical background

Challenge funds have been widely used in medical and academic research, as well as the social sectors. Some of the first challenge funds were for inner-city regeneration in the UK – the City Challenge, Rural Challenge and Single Regeneration Budget Challenge Funds – launched in the early and mid-1990s. All were built on the need to stress tripartite partnership between the public, private and community sectors. One of the most controversial features of the funds was the distribution of resources according to competitive bidding, rather than socioeconomic indices.

DfID pioneered the use of challenge funds in development as a means of engaging the private sector more directly as partners. The UK government, in general, and DfID in particular, saw the funds as an effective and competitive mechanism to persuade the private sector into leveraging DfID's core funding. According to this view, the private sector is increasingly considered a key partner in finding solutions to poverty reduction. According to Irwin and Porteous (2005), DfID envisaged that challenge funds would provide:

- A transparent and competitive process for the allocation of public funds
- Local solutions to local problems with responsibility for choice devolved to where the impact would be most felt
- An opportunity for capacity building
- A stimulus for innovation and risk-taking that also provides motivation to disseminate good practices and promote replicability
- A partnership approach that includes co-funding of projects, and sharing of skills and experience.

Challenge funds are similar in some respects to other funding instruments, such as direct accountable grants and social venture capital, but there are important differences as shown in Table 1:

Table 1: Challenge fund features

Features	Discretionary grants	Challenge-type fund	Social venture capital
Deal flow	Identified by project officers, often from unsolicited approaches	Advertised and open to all who qualify	Usually solicited via networks
Selection mechanism	In line with programme	Eligibility criteria Competition (in rounds)	Eligibility Due diligence
Decision-making	By donor according to size	By panel	Investment committee/ board
Matching	Varies	Varies	Typically minority share Only. i.e. >1:1
Monitoring	Ranges from light touch to quite intensive	Ranges from light touch to medium touch	Intensive engagement ex post

Source: Financial Deepening Challenge Fund Strategic Project Review (Irwin and Porteous, 2005)

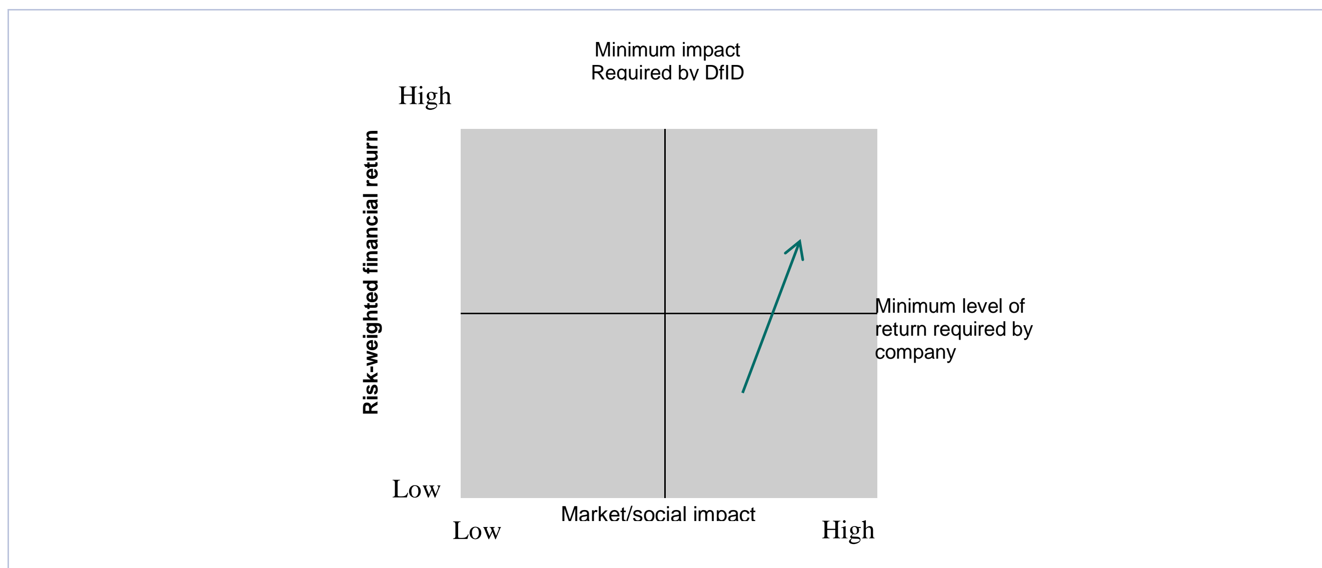
DfID created the Financial Deepening Challenge Fund (FDCF) and the Business Linkages Challenge Fund (BLCF) in 1999 as a means of providing financial support to business. The funds were piloted in East Africa before being rolled out to Southern Africa, South Asia and the Caribbean. Thereafter, other donors recognised that such funds could complement their own approaches. In 2002, the Consultative Group to Assist the Poorest (CGAP) launched the Pro-Poor Innovation Challenge (PPIC) to provide grants to microfinance institutions with innovative methodologies to deepen rural-poverty outreach and impact. AusAID and CIDA soon established funds, and the United States Agency for International Development (USAID) launched large-scale efforts, such as the Public Private Partnership Challenge Fund and the Gender Challenge Fund.

Challenge funds vary in size: Grand Challenge Canada, which focusses on innovations in health, has a budget of C$225 million while the DfID/Asian Development Bank (ADB) fund in Vietnam is only US$3 million.

3.2 How challenge funds work

Challenge funds aim to mitigate against risk in markets where business can contribute to poverty alleviation. One of the main characteristics of a challenge fund is its open, competitive application process, which provides applicants with a one-off, limited-duration grant to overcome the uncertainties that inhibit innovation, research and development, investment and new approaches. The assumption is that without challenge-fund support, such activities are either unlikely to happen, or will happen at a later stage.

Figure 1: Moving attitudes to risk



Source: Financial Deepening Challenge Fund Strategic Project Review (Irwin and Porteous, 2005)

The most important feature of the challenge fund is the 'challenge', which must be widely promoted and have clear eligibility criteria if it is to elicit a wide array of applicants from the private sector. The goal is to produce a large pool of intelligent and unconventional solutions to longstanding problems in development by tapping the ingenuity of private enterprise.

Challenge funds call for companies, organisations and institutions working in a specific field to submit project proposals. While the funds are usually set up to meet specific goals – such as extending financial services to the poor, finding solutions to health problems, nurturing investment in high-risk markets, stimulating innovative use of resources, and so on – their applicability in creative problem-solving in developing countries is very wide. Firstly, proposals are evaluated against transparent and pre-determined criteria; successful applicants usually match a percentage of the grant with their own financing; and the challenge fund provides grants to projects that best meet its objectives, while still fulfilling the eligibility criteria.

3.3 Characteristics of challenge funds

Some shared characteristics of challenge funds, regardless of objectives, are:

- *Competitive process:* at their core challenge funds are an instrument for competitively tendering matching grants. A challenge is issued in the public domain which is open to all who are willing to compete, bid and achieve. Competitive allocation of funds guarantees that only the best projects are funded. Since challenge funds provide once-only funding, winning companies are free to plan their exit strategies – which are clearly defined and time-bound – minimising any anti-competitive effect.
- *Innovation:* challenge funds require innovation from bidders if they are to win support for their ideas. Applicants are invited to submit potentially transformational business plans that can contribute to achieving development objectives. Since an underlying assumption is that innovation carries risk, one of the challenge fund's main goals is to hedge against loss, promote innovation and, in doing so, to increase access and choice for the poor.
- *Leverage:* challenge funds provide co-financing for successful projects on a grant basis. Successful applicants match a certain percentage of the grant with their own funds. This promotes ownership and commitment, and ensures public funds go further.

- *Partnerships:* challenge funds are useful for bringing together partners from the private, public and not-for-profit sectors in a framework of cooperation for mutual benefit.
- *Local solutions to local problems:* challenge funds encourage bidders to develop ideas that provide local solutions to local problems, stimulating ownership and greater innovation.

3.4 Rationale of challenge funds

According to SIDA's challenge-fund guidelines, the donor community interest in challenge funds arises from a combination of factors:

- Overseas Development Assistance is trying to engage more actors in development, particularly from the business community; challenge funds are an effective way of doing so.
- Competition is used to find the most intelligent and cost-effective solutions to accomplish development goals.
- Innovation – increasingly prized for offering simpler solutions to issues of poverty and the environment – lends itself to the challenge-fund concept.
- Challenge funds leverage donor funds by engaging private capital through matching finance.
- Challenge funds allow for direct engagement with commercial stakeholders without creating market distortions.
- Challenge funds differ from conventional, competitive-bidding processes because: they focus on a desired outcome without prescribing the means to achieve it; and allow for multiple winners.
- Challenge funds are a way for donors to strengthen links with domestic and partner-country businesses, and to promote private-sector development by part-subsidising the latter's companies.

3.5 Impact

Although considerable funding has been allocated through the mechanism of challenge funds, there is little evidence of their long-term effectiveness. As Heinrich (2013) points out, results tend to be anecdotal, focusing more on individual narratives than ultimate impact. The Donor Committee for Enterprise Development (2013) argues that there is no conclusive evidence that challenge funds generate systemic change, and this poses a risk in the future of challenge funds.

Evaluations by the Emerging Markets Group and Irwin and Porteous – for the BLCF and FDCF, respectively – found that both funds demonstrated positive results in helping the private sector to overcome the initial risk of projects through the provision of cost-sharing grants. According to Isenman et al (2010), while these evaluations did not rigorously separate correlation from causality, or take full account of the preparation costs of projects that were not approved, the analyses seem reasonable and the results credible.

To some extent, all challenge funds should be viewed as investment portfolios, with some specialising in pro-poor innovations. Many such portfolios have been evaluated for financial viability, market impact and/or pro-poor impact, but most evaluations failed to assess them in terms of market segment. It can be argued that this was due to the design of challenge funds. For many, their selection criteria tended to exclude smaller companies due to the eligibility criteria, such as requirements for matching funds, financial solvency and corporate social responsibility. In their evaluation of the FDCF, Irwin and Porteous (2005) were highly critical of the goal of 'increased productivity and new business start-ups in the small and medium enterprise (SME) sector targeted by challenge fund projects' since, according to the authors, most of the fund-supported projects had nothing to do with encouraging small business start-ups. With appropriate systems in place and relevant experience, multinationals and large companies tend to benefit more from challenge funds. However, one disadvantage of working with large companies is the difficulty of achieving buy-in at senior level – compared with smaller companies run by entrepreneurs. Working with large companies also entails slower processes since decision-making is less flexible.

The Ford Foundation's Vietnam Business Challenge Fund (VBCF), organised through the Vietnam Chamber of Commerce and Industry, advertised through small-business associations at provincial level. Applications, therefore, tended to come from small businesses. As the VBCF's fund manager pointed out, SME involvement largely depends on a fund's objectives. The VBCF's goal, for example, is to maximise systemic change, which can more easily be achieved through medium-to-large enterprises. Nonetheless, about 25% of VBCF's portfolio is composed of small businesses. For small businesses to succeed in a challenge fund, they need to have proven technical expertise and capacity. As the VBCF's manager explained, the fund is willing to share risk in new markets and products/services, but not in technical expertise/capability.

KPMG Development in Practice (2012) found that challenge funds encouraged better business practices among grantees because their criteria require solid corporate governance and transparent financial management. Grantees said they had used grant funds to upgrade internal systems, and learned about community engagement by adopting environmental, social and governance principles. KPMG argues that such experiences help businesses to improve; prepare entrepreneurs to engage at a higher level in global markets; and facilitate interest from foreign investors who expect stricter standards of governance in business partners.

Challenge funds can also have a catalytic effect, encouraging businesses to adjust their thinking about markets and people, KPMG argues. Ultimately, exposure to commercially viable, pro-poor innovations expands the private sector's understanding of what is possible – and profitable – in low-income markets.

Evaluations of other funds have also shown positive results. By July 2012, AusAID's Enterprise Challenge Fund (ECF) had affected 348,460 poor people, of who 50,053 benefitted from increased earnings and reduced costs, equivalent to an increase of A$1.5 million in annual net incomes. DfID's Financial Education Fund (FEF) was created in 2008 to increase financial literacy and access to financial services among poor people in Sub-Saharan Africa. Evaluations found that recipients of financial education demonstrated increased awareness of key financial issues, made less risky financial decisions and showed other improvements in their financial management.

Evaluations of the multi-donor Africa Enterprise Challenge Fund (AECF) showed that nine of the 29 projects supported achieved a combination of 'high' social impact and financial returns, while most of the remainder achieved 'reasonable' social and financial returns. The £15 million invested in the AECF have leveraged £72 million in matching funds from the private sector. Results published in 2011 showed net benefits of US$54.4 million for 577,361 rural households (an increase of 319,065 beneficiary households since the projects started); US$3.7 million in increased wages for 1,577 new employees; and increased turnover among grantee businesses of US$58.4 million. Conditions for a successful challenge fund

Based on the available evidence, the underlying conditions for a successful challenge fund include:

- The challenge, or issue, is better addressed by business/private sector, than by state organisations, NGOs, research institutions, etc.
- The challenge is one for which commercially viable solutions are not currently available, and which businesses are reluctant to address due to perceived risk.
- A number of businesses should be interested in the challenge, thereby attracting enough applications to allow for real competition.

4 Designing a challenge fund

4.1 Overview

4.1.1 Objective of the fund

The rationale for a challenge fund must be clear and explicit. This will not only justify donor funding, it injects transparency into the application and selection process. Goals vary broadly across funds: a specific challenge fund should address a significant development issue that market forces would not otherwise consider.

The benefits of applying the challenge-fund model, as against another method of support, must also be explicit. Challenge funds require close administration, with high associated costs. Demonstrating how a challenge fund is more appropriate than other funding mechanisms is vital if the increased costs are to be justified.

SIDA's guidelines provide three criteria that should be applied in designing a challenge fund:

- **Systemic impact:** when there is impact beyond the micro level, for example in structural changes to an economy through innovation
- **Additionality:** if the development innovation would not have proceeded otherwise, for example through market forces and/or commercial financing
- **Positive externalities:** when the positive impact of a project goes beyond what a commercial investment would capture.

4.1.2 Eligibility

Eligibility criteria vary from fund to fund. Some, such as AECF, are only open to private companies; some, like Innovation against Poverty (IAP), are open to companies and other entities with a commercial orientation; while others are open only to NGOs. Some funds cater only to own-country organisations, such as SIDA's Demo Environment and some of DfID's smaller funds. By contrast, AECF and IAP are open to applicants globally. Some funds allow developed-country companies to apply, but they must spend a percentage of the finance in the fund's country of operation.

Some of the most common eligibility criteria that challenge funds use are:

- Proven track record by the company and/or organisation
- Proven track record of legal and ethical operations
- By-law and at least two or three years in operation
- Financial solvency
- Audited accounts
- Corporate social responsibility policy
- Not involved in unethical activities, such as arms production or tobacco.

The Mohammed bin Rashid Al Maktoum Foundation's Child Education Fund employs the following eligibility criteria:

- Registration in one of the 22 countries of the League of Arab States (Algeria, Bahrain, Comoros Islands, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, UAE and Yemen).
- Owners of candidate businesses must be citizens of one of the 22 members of the League of Arab States, and between 18-35 years old.

- Applicants must be a start-up or early-stage business with less than two years in operation.
- Applicants must demonstrate the expertise to undertake the project.
- Applicants must contribute at least 20% of the required project costs (in cash or equivalent).
- Applicants must adhere to minimum levels of corporate social responsibility.
- Note: Business membership associations and NGOs are eligible to apply, provided they are in a partnership led by an eligible, private-sector business.

Some of the above requirements reduce the risk of fraud, corruption and reputational damage to the donor, while ensuring the applicant has the ability to meet the challenge.

4.1.3 Geographical coverage

Challenge funds may cover a single country or an entire region. DfID funds target one country, such as Vietnam, Ghana and Afghanistan, or regions, such as Sub-Saharan Africa. The Girls Education Challenge Fund (GEC) focuses on 22 countries; AusAID's ECF targeted nine countries in the Asia-Pacific region; and the Enterprise Innovation Challenge Fund (EICF), assembled by the IADB, CIDA and DfID, specialises in the Caribbean.

The literature indicates that narrow geographical region or a single-country focus offer greater local impact and easier management, but also the risk of a shortage of applicants of sufficient quality.

4.1.4 Additionality

SIDA argues the need to consider additionality as a criterion for project selection. SIDA points out: 'A fund that provides grant financing to projects, which anyway would have taken place through private capital, has wasted its resources.' Listed below are a series of questions that IAP provides to measure additionality.

Assessment criteria
Projects should be assessed regarding the extent to which the challenge fund support makes a difference to the chances of the project achieving commercial sustainability and development impact. Questions to assess these criteria include: • Would the project take place at the same scale or rate, or have same development impact in the time-frame without challenge funding? • Is the project able to secure funding from other sources? (If not, these reasons should be explained). • Would the project be implemented differently with challenge fund support? • What is the risk the challenge fund bears that the project will not achieve its stated development and commercial objective? Vis-à-vis, what is the development impact that will be achieved if the project is successful? • In this regard, where does the project lie within a risk/return portfolio for the challenge fund beneficiary projects?
Basics of what the challenge fund is looking for
Regardless of whether challenge funds focus on smaller or larger grants, they should look for projects which: • Will be considerably bigger, better and quicker, thanks to the funding • Where the potential development impacts are proportionate to the risks of not achieving results.
Making the case for additionality
Applicants can help make the case for additionality by: • Explaining how access to the funds would add significantly to the success of their projects • Providing a clear explanation of how fund support will reduce risk and increase the probability of accomplishment.

Source: A guide to IAP assessment criteria (SIDA)

4.2 Structure

4.2.1 The application of different windows

Some large challenge funds, such as the GEC, EICF and AECF, have separate 'windows' to tailor applications to specific purposes or targets. The structure of windows allows for possible growth, and reduced management and transaction costs, while helping to maintain clear goals. Multiple windows also allow for fewer rounds of competition for specific goals when there is a limited supply of applications.

GEC recognises that stimulation may be necessary to encourage new partners to engage and that some projects need lower, initial levels of support to demonstrate their effectiveness. This is why GEC adopted the multi-window approach:

- The 'small-scale pilot project' window is directed at projects that are more innovative, and need further testing before moving to scale. Projects in this window are valued at between £250,000 and £2 million.
- The 'strategic partnerships' window provides funding of up to £15 million to projects that develop new ways of meeting the fund's established objectives. This window is specifically aimed at attracting proposals from the private sector.
- Through its 'step change projects' window, the fund supports individual projects of up to £30 million that demonstrate the ability to deliver results quickly and effectively.

4.2.2 Grant size

Funds usually establish a minimum grant size to avoid disadvantageous transaction costs for both parties. As stated above, the management costs of a challenge fund are usually high, regardless of grant size, and applicants will incur administrative charges related to filing applications, project management and reporting. This makes small grants less attractive. AECF has set a minimum grant of US$250,000 per project. IAP has not established a minimum, but directs smaller applications to its small grant facility, which provides funding to up to €20,000.

Some funds have established both a minimum and a maximum grant size. SIDA has a ceiling of €200,000 for both IAP and Demo Environment. GEC provides a maximum of £30 million at its step change window; the innovation window supports projects ranging from £250,000 to £2 million; while the strategic partnerships windows fund projects of up to £15 million.

There is no ideal minimum or maximum grant size; the amounts should reflect the fund's purpose and objectives. Smaller grants may be more appropriate for a fund that focuses on earlier stages in a commercial endeavour where risk is often higher, and with a streamlined application process. It may be that a higher minimum, as with AECF, favours multinationals while discouraging local companies due to the matching-fund requirement, an issue that has been raised in previous fund reviews.

4.2.3 Targeting companies and marketing the fund

The success of a challenge fund relies on its ability to attract good applications from a wide range of organisations. The traditional approach has been 'hands-off'; the information is put in the public domain and the opportunities for grant support are publicised. Behind this approach was the assumption that straightforward criteria would inspire the private sector to respond with competitive projects; the fund's chief task was to identify those worth supporting. While this approach was relatively successful in developed countries where the pool of applicants is more sophisticated, it hit setbacks in developing countries, prompting a more proactive approach to marketing and bidder guidance. Marketing a fund in a particular sector requires a close reading of the businesses operating in that sector, and the opportunities and constraints they typically face.

This more energetic approach entails targeted marketing and the recruitment by donors and fund managers of specialised agents. While a well-developed and easy-to-find website is considered crucial to any fund campaign, IAP went a step further by mounting a 'road show' and AECF hired a global public relations company to refine its image through a new logo and marketing strategy. Fund

managers must strive to find a balance between stimulating a response and favouring a particular kind of business. To avoid the latter, information about specific market opportunities must be available equally to all players.

Irwin and Porteous (2005) argue that it is vital to identify all the stakeholders early in the marketing design stage, to understand who needs to be influenced, and when. Key messages need to be defined and communicated to each group of stakeholders. They argue that marketing works best when 'it is accurately targeted, first at firms who may be interested and secondly at specific individuals within those firms.'

Specific marketing strategies used in the past include: targeting the corporate social responsibility programmes of larger firms as an entry point; press coverage in leading newspapers; working with business associations, especially trade associations; organising workshops; and convening conferences.

Fund managers should realise that there is only a limited number of potential applicants in a given market and that, as the ECF recognises, 'with appropriate facilitation the weak ideas of today might become the pioneering projects of tomorrow'. Feedback on failed concept notes should be viewed as a strategic prompt for on-going marketing. The costs of marketing should be considered part of the fund's management fees.

4.2.4 Technical assistance

IAP and the Mohammed bin Rashid Al Maktoum Foundation's Sawaed Challenge Fund (SCF) established technical assistance components to help applicants with their business plans, project proposals and general business advice. SCF also deployed a team of volunteer mentors to advise applicants in a number of countries. Applicants can access mentors on the SCF website and contact them directly.

BLCF provides a good example of how technical assistance can be useful. Early bidding rounds stimulated interest from the private sector, but the disappointing quality of proposals emphasised the need for more intensive engagement with applicants prior to the submission of concept notes.

A technical assistance component makes most sense for challenge funds working with small companies that might benefit from the additional support.

4.2.5 Number of rounds or openings

It is advised that challenge funds set precise deadlines for applications. Funds usually hold one or two rounds a year because of the demands that administration and selection make on time and resources.

4.2.6 Duration

Challenge funds are usually time-limited, for example operating over five years with a fixed number of rounds. While nothing prevents a fund extension, a specific time-frame encourages participant companies to design their exit strategies. For example, GEC is designed to operate beyond 2016, but will not issue new funding after March 2016.

The duration of each round depends on the challenge fund. For AECF, funding approval for successful proposals is granted within 240 days of the applications deadline. CGAP's PPIC operates a turnaround policy of three months from round-opening to funding approval, while FDCF and BLCF have a six-month cycle. In the VBCF's first round, the application phase lasted two months; screening and revising applications took a further month; after which shortlisted candidates were invited to submit business proposals. Bidders are given two months to complete their business plans, while VBCF conducts due diligence. Business plans and due-diligence results are then forwarded to a panel for final assessment lasting two weeks, after which the fund enters contract negotiations with the selected companies. This final phase lasts from four to six weeks.

Implementation can take from two to four years. For VBCF, implementation takes only two years which, it acknowledges, may be a limiting factor. The GEC operates a four-year implementation cycle.

One critical limitation of challenge funds is that many have insufficient funding to function long enough to ascertain their projects' ultimate impact. Challenge funds may be an effective mechanism for selecting projects, but they are not always good at evaluating outcomes.

4.3 Applications process

Some challenge funds are structured so that the application process consists of two phases, reducing administrative costs. In the first phase, applicants submit an outline of one or two pages, pending short-listing by an investment committee. Successful candidates are invited to develop a full proposal, usually in a business-plan format. The investment committee, which might include donor representatives, then selects winners based on the criteria and the completed applications.

Experience indicates that online application and easy access to the eligibility criteria are essential.

When selecting proposals, it is important to realise that excellent proposals may reflect a consultant's skill rather than the quality or commitment of a company. Even when consultants are not involved, some companies have more experience of bidding processes, which may improve the quality of the proposal but not necessarily the quality of the project.

Other challenges that arise during the application process include: unexpected volumes of interest; very varied proposals; and the need to balance a range of factors when selecting projects for support.

Award ratios, in general, are in the order of one or two for every 50 applications, with most funds applying the two-phase system of initial 'concept note', followed by full business plan.

4.4 Costs, financing and administration

4.4.1 Costs

The two main costs of challenge funds are: i) the total amount to be given as awards over the duration of the fund, and; ii) the management and administrative costs, including marketing, support for an independent evaluation team, audit reports, etc. Consideration should also be given to the following:

Project costs

The challenge fund must clearly define what are project costs – and therefore financed by the grant – and what are not. DfID provides a list of non-project costs that includes: land purchases, construction costs, major capital expenditure, depreciation, debt repayment, design costs, baseline surveys, contingencies and core costs not directly related to project implementation.

Sunk costs

Most applicants have sunk costs, such as investments made prior to application that are still necessary for the project. Typically, challenge funds do not cover sunk costs and they cannot be included as part of the applicant's matching fund, or for refunding. This must be made explicit in the application guidelines.

Cost sharing/matching funds

Most business-oriented funds use a cost-sharing formula in which the applicant covers at least 50% of project costs from its own resources. The percentage of matching funds can vary: SCF provides up to 80% of funding, while SIDA's requirement depends on if the applicant is a private or a public entity. Matching funds are used to guarantee an applicant's commitment, but also to leverage donor funding.

To avoid uncertainty in the application process, detailed information must be provided on eligible and ineligible costs, and how they should be calculated for matching funds. Some funds require cash as part of the matching arrangement, which is easier to calculate and manage, but this condition may discourage some promising applicants.

4.4.2 Use of different financial mechanisms

Most funds operate with grants, but AECF and others employ different financial mechanism, such as repayable loans or a combination of both. Under the repayable loan mechanism, 'a loan is due to be repaid only if a project is commercially successful, otherwise it is written off.' The repayable loan option is administratively more complex and critics argue it may attach a 'perverse incentive' – insofar as applicants have an incentive to fail. However, it also provides donors with more leverage and the funds to support more projects.

4.5 Fund management

4.5.1 Outsourcing fund management

A common donor practice is to outsource the management of challenge funds to external organisations, due to the high administration costs. Outsourcing is conducted through competitive bidding. DfID has selected management consulting companies such as PwC, KPMG, Landon Mills, Coffey International and Nathan Associates are responsible for the management of the funds, which is the same case for other donors. The outsourcing is the preferred option for the GEC, which is managed by PwC.

4.5.2 Fund management costs

Fund management costs are not made public but, according to Irwin and Porteous (2005), typically range from 12-24%. The management fee for AECF, according to SIDA, is around 20% of total budget but for AusAID's ECF – including fund marketing and the cost of an independent monitoring team – it rises to 30% of total budget over a six-year period. PwC's fee for managing IAP amounts to 50% of total donor funding over a three-year period. The high cost associated with IAP was due to inexperienced companies and NGOs, entailing additional support in the contracting process. AECF has introduced a performance bonus as part of its management charge; fees are linked to performance indicators, output levels and annual targets, agreed beforehand.

Some fund managers interviewed vigorously opposed the calculation of management costs as a percentage of the total fund. More appropriate, they suggested, was the venture capital fund model of management costs, which are typically quoted as an annual percentage of funds invested. They iterated that overall percentage is less important when calculating cost than the fund's duration and the number of deals it secures. When costs are thus disaggregated, they tend to support the cost-effectiveness of the challenge-fund approach.

4.5.3 Leverage ratios

The leverage of private capital through challenge funds varies from 1:1 to 1:4, depending on company size. Challenge funds working with multinationals anticipate greater leverage than those targeting SMEs.

4.5.4 Investment committees/external review panels

Many funds introduced the role of investment committee or external review panel, a body independent of donors and fund managers, which is responsible for project selection. Investment committees include subject specialists, and often add to a fund's prestige by attracting more and better applicants. An investment committee must be completely independent and act according to clear criteria if the fund's reputation is to be protected.

4.6 Governance

4.6.1 Programme manager

Challenge funds maintain high profiles. It is not in a donor's best interest to be involved in the fund's day-to-day running, but it should keep engaged in its strategic development and management. The donor designates a programme manager to provide oversight of, and guidance to the fund. The programme manager works within the donor agency and is responsible for the fund's overall development.

The programme manager's task requires significant amounts of time in the fund's early phases, eventually decreasing as operations are established. With the support of an advisory board, the programme manager ensures: the fund has well-defined priorities; the fund manager has clear performance targets; regular assessments are made of the fund manager's performance; and the fund is being championed from within the organisation.

4.6.2. Investment committees/external review panels

Multi-country funds benefit more from a dual investment committees/external review panel structure, with one local and one international panel. The international committee/panel ensures awards are equitably distributed and that all regions benefit. Proposals involving activities in several countries should be referred to the international committee/panel.

The committee/panel must have an appropriate balance of members with commercial experience, pro-poor and donor-activity backgrounds. A committee/panel should not exceed 10 members and its composition should be based on the availability of qualified people – and no other configuration. Gender balance and geographic representation are important elements to consider when selecting members.

Committee/panel members are usually identified through consultation with stakeholders, including donors, business associations, businesses and NGOs. Research shows that international members are often willing to work pro-bono if expenses are covered, but local members require a fee for their time. The cost is part of the budget.

It is suggested that committee/panel members remain anonymous to prevent decisions being made under pressure. Each committee/panel should have a designated chair.

4.6.3 Reporting

Regular reporting is important for the maintenance of communication flow, and to identify/rectify problems in good time. Funds usually provide grantees and fund managers with quarterly or bi-annual reports.

The contract between the fund and a grantee should specify when the latter must report and what benchmarks are used for future disbursements. Grantees should report on the progress of the project and how it is meeting intended outcomes. A project's failure to meet benchmarks should result in a suspension of disbursements until it is back on track.

The fund manager's report provides a detailed summary of the performance of the fund, its funded projects and an up-to-date assessment of the impact of the entire portfolio.

4.7 Monitoring and evaluation

One of the fund manager's most important tasks is to take the lead in conducting follow-up, providing support and monitoring projects to ensure they deliver the agreed results. Monitoring systems should be designed in advance. They are a management tool, complemented by evaluations to assess impact, cost effectiveness and lessons learned.

When evaluating impact, challenge funds should assess the achievements of projects in terms of accomplishing the agreed goal and its impact on poverty reduction. Most funds prefer independent impact assessments, outsourced to another organisation, but using information provided by the fund manager. Some of the criteria used to assess challenge funds are:

- Relevance – do the projects address the fund's objective?
- Impact and effectiveness – what has been achieved?
- Efficiency and cost effectiveness
- Sustainability.

AusAID’s ECF is a good example of a fund with a strong, impact-assessment orientation. ECF contracted an independent monitoring team in parallel with the fund management; conducted a mid-term review in its third year of operation; and provides annual progress reports. GEC contracted in parallel an evaluation manager to conduct independent monitoring and evaluation throughout the fund’s lifetime.

5 Challenge funds and education

5.1 Girls Education Challenge Fund

With a £355 million investment over a four-year period in 22 countries, the Girls Education Challenge Fund (GEC) is one of the of the UK’s most ambitious programmes. The GEC aims to provide 650,000 marginalised girls with a complete, six-year cycle of primary education and one million girls with three years of junior secondary school. DfID forecasts a 25% increase in the number of girls achieving a pass/standard at the required level in all programmes the GEC supports.

The GEC operates through three different funding windows:

- *Strategic partnerships - investing in business innovation and partnership for girls’ education:* funds new projects aimed at supporting girls’ education with a value of up to £15 million, matched by funding from the private sector. Although the funding round has now closed for this window, results will not be announced until later next year. Selected applicants must submit a full partnership proposal.
- *Step change window:* about two-thirds of all GEC funding is allocated through the step change window, which supports projects worth up to £30 million. Projects should help to mobilise and build capacity within governments, communities and schools, or train and mentor teachers, governors and community leaders. There is also an emphasis on innovation – encouraging new ways to deliver learning. Projects in this window are led by non-state organisations and must be able to expand educational opportunities to marginalised girls rapidly. They complement existing support to education and need to demonstrate sustainability beyond the GEC’s lifetime.
- *Innovation window:* nearly a third of GEC funding is allocated to ‘innovative projects’, small-scale projects worth up to £2 million that pilot new ideas. The fund has received over 1,000 concept-notes for this window in priority countries, with 70 applicants invited to submit a full application. Final selection has still to be announced.

The GEC is managed by a consortium led by PwC in alliance with FHI 360, Nathan Associates and Social Development Direct.

5.2 Child Education Challenge

Mindful of the challenges the Arab world faces in providing high-quality child development and education, the Mohammed bin Rashid Al Maktoum Foundation launched the Child Education Challenge Fund in 2009. The fund is open to start-up and early-stage companies (with less than two years in business), and focuses on child development and education.

Projects need to meet the following criteria:

- Have commercial viability and potential for the replication of innovative products and services

- Develop innovative programmes, tools, and other resources that:
- Target children up to 18 years of age
- Include Arabic language in their content
- Improve the quality of practices in childhood education
- Support integration of technology in children's intra-curricular and extra-curricular activities by enhancing digital literacy
- Create innovative platforms that ease access to knowledge, education and improve learning abilities.
- Promote children's social, cognitive and general knowledge
- Are unable to source sufficient funding to undertake the project
- Can be completed within two years of the start of the project
- Are sustainable, or result in sustainable impact after the grant has been used.

No further information about grant size, previous winners and project evaluation and/or impact assessments is available.

5.3 Technology Literacy Challenge Fund

Launched by former President Bill Clinton in 1996, the Technology Literacy Challenge Fund (TLCF) was the single largest investment devoted exclusively to increasing the use of technology in elementary and secondary education in the United States of America. TLCF funding was used to leverage private-sector participation, with less emphasis on long-term sustainability partly because it was a state-sponsored fund. With overall capitalisation of US$2 billion the fund aimed at encouraging local communities, companies, universities and others to work towards fully integrating technology into the curriculum, and to improve teaching and learning. The TLCF had four pillars:

1. Provide teachers with the training and support to help students learn through computers and the information superhighway
2. Develop effective, engaging software and on-line learning resources as an integral part of the school curriculum
3. Provide access to modern computers for all teachers and students
4. Connect every school and classroom in America to the information superhighway.

US states were asked to present a state-wide strategy to meet the TLCF's challenge, and were given maximum flexibility to accomplish its objectives. To receive funds, states needed to meet the following three objectives:

- *State strategy*: Each state must develop a strategy to empower all of its schools to meet the goals outlined by the president. These strategies ensured that every district and school, from the suburbs to inner cities and rural America, fully participated in the initiative. Strategies included benchmarks and deadlines for accomplishing goals, but it was the state, not federal government, that set targets and methodologies.
- *Private-sector partnership and matching requirement*: State strategies had to involve private-sector participation and commitment to meet the four pillars. Private-sector commitments had at least to match the amount of federal support. The match could be met by volunteer services, cost reductions and payments for connections under the Universal Service Fund provisions of the Telecom Act, and a host of other commitments.
- *Annual progress report to the public*: To ensure accountability, the state had to report to residents at the end of each school year on progress towards achieving benchmarks, and how it met its strategic objectives most cost-effectively.

The fund also employed a multi-window approach: one, the Local Innovation Challenge Fund (LICF), targeted areas where the state did not have a state-wide strategy. Consortia of private companies and local communities were eligible to compete for LICF support, worth some $50 million per year.

TLCF-funded projects across the nation tended to follow the same pattern as Connecticut where 4,000 volunteers wired 600-700 of its 1,600 schools and libraries with the help of 100 small businesses, large corporations and non-profit organisations. Indeed, most projects and awards focused on wiring schools; few included software development or teacher training, areas where the private sector might have found better opportunities.

5.4 Financial Education Fund

DfID launched the Financial Education Fund (FEF) in 2008 with the aim of establishing financial education as way of reducing poverty in Sub-Saharan Africa by:

- Promoting access to finance and financial inclusion
- Increasing financial literacy through education initiatives
- Demonstrating a contributory effect on financial capabilities.

After two competitive application rounds, FEF selected 15 projects in eight Sub-Saharan countries. Projects included a number of delivery channels and different target audiences to determine the comparative effectiveness of different financial-education models to equip poor people with the skills to manage their own finances and protect them from exploitation.

Examples of projects funded include:

- uBank's Nakekela Imali project facilitated training sessions on personal financial management with migrant mineworkers in South Africa.
- The South African Insurance Association launched a radio drama focused on financial knowledge, attitudes and behaviour, broadcast over 52 weeks by four radio stations in local languages.
- Finlit Uganda, through its Tegeera Ssente Zo ('Know Your Money') project, introduced: a financial log-book so clients could track financial behaviour; and specialised software to give clients visual forecasts and help them improve their financial managements, with monthly interactions over a six-month period.

5.5 Challenge Funds in Indonesia

5.5.1 Enterprise Challenge Fund

The Government of Australia established the Enterprise Challenge Fund (ECF) over a six-year period to fund businesses with innovative solutions to market failures and to stimulate long-term, inclusive pro-poor, economic growth in Asia and the Pacific. The fund was open to business applicants in Cambodia, East Timor, Fiji, eastern Indonesia, Lao PDR, Papua New Guinea, southern Philippines, Solomon Islands and Vanuatu.

Businesses are delivering 21 projects in Cambodia, Fiji, Lao PDR, Papua New Guinea, southern Philippines, Solomon Islands and Vanuatu. Though open to applicants in southern Indonesia, no projects are currently funded there.

According to the research, ECF was the only challenge fund operating in Indonesia.

6 Risks of challenge funds

6.1.1 Insufficient high-quality proposals

There is always a risk that too few bids are submitted, or that they lack the quality to be funded. To protect against this, an indicative assessment of potential partners' likely interest and absorptive capacity should be conducted early in the design phase to ensure the fund's objectives are relevant. It is important to be transparent about the scoring process and to invite questions before the submissions deadline. Market testing and a high-profile launch can help to attract bidders' attention to the offer.

6.1.2 Lack of innovative proposals

Proposals may be very similar to other projects or activities, or not involve new organisations or partnership approaches. Again, clarity about expectations is vital; the prioritisation of innovation in the scoring criteria, creation of a special 'innovation window' and the allocation of more fund- manager time to developing innovative proposals are all helpful.

6.1.3 Lack of private-sector interest

The private sector may exhibit lack of interest and/or not submit proposals before deadline. A high-profile launch with representatives of the private sector may prevent this from occurring. The fund manager should undertake to engage directly with representatives of the private sector to encourage proposals.

6.1.4 Projects funded are not sustainable

Priority should be given to projects that demonstrate sustainability beyond the funding cycle and which have a sound financial foundation.

6.1.5 Fund management is unsatisfactory

Signs of weak management include: a fund manager's failure to approve funding within the agreed timeframe; and the high costs of administration. Donors should establish a thorough procurement process, setting clear terms of reference and performance targets. Priority should be given to projects with a results-based approach.

6.1.6 Fraud

Clarity is required on the permitted use of funds. Fund managers must establish robust financial controls, and conduct due diligence and project supervision in the field. Independent audits should be used to identify potential wrong-doing.

7. Some lessons learned

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; that is to say, the extent to which funded projects create structural changes that impact poverty. Nonetheless, some of the key lessons learned and best practice from challenge funds include:

Challenge funds are a mechanism whereby the public sector engages with the private sector to achieve mutual goals. Whatever their promise, it is important that challenge funds:

- Are demand-driven and encourage the private sector to provide solutions to public-sector objectives

- Are widely publicised to ensure all eligible organisations have an equal chance to compete for funds
- Maintain a competitive process by setting strict deadlines
- Require matching funds to ensure resource mobilisation and commitment to selected projects
- Rely on the private sector for project implementation.

Coverage

- Sector or geographical focus funds are more likely to achieve systemic change.
- Some funds cover different areas within a specific sector, thereby encountering a set of interlinked difficulties. A fund that addresses more than one sub-sector must appraise its overall sectoral expertise if it is to make adequate proposal assessment and provide the necessary support to applicants.

Clear objectives

- Clear and achievable objectives must be set from the outset.
- Challenge funds should be viewed as a mechanism that complements other donor activities.
- The log frame should be designed so that clear links are established between outputs and objectives.

Eligibility criteria

- The fund manager should have the flexibility to adapt to the changing needs of the fund and of the companies that apply to it, just as companies need to be flexible about their own models.
- If innovation is a criterion, it must be applied with regard to local circumstances. Innovation means different things in different places. Simple improvements, such as introducing existing products or services to a virgin market, also count as innovation.
- Avoid funding the development of new technologies that may involve issues related to intellectual property rights. Instead, explore supporting the deployment of the new technology.

Targeting companies and marketing

- Targeting companies and marketing the fund should be recognised as crucial aspects of strategy from the outset. Proactive approaches to marketing are more effective than 'softly-softly' ones.
- Marketing produces better results when targeted at companies with a potential interest and at specific individuals in those companies.
- Traditional public relations strategies, such as advertising, conference marketing, and a coherent and accessible website, are vital to promote the fund.
- Marketing efforts should be directed not only at firms that previously benefited from donor support, but should seek to attract new partners.

Fund management

- Outsourcing fund management to an independent organisation through competitive bidding is common practice among donors, and helps to ensure professional and efficient administration.
- Challenge funds that provide sizeable grants are not 'light touch'; management costs may consume a significant part of the budge.
- To be successful the fund manager needs to adapt his role over the life of the fund, from marketing to support to bidders and, later, to support to grantees.
- The private sector is used to moving quickly and is frustrated when others cannot to do the same. Fund management should abide by this expectation.

Applications process

- The fund manager plays a key role in introducing prospective partners to each another.
- Focusing on the commercial sustainability of a proposal provides an alternative means of assessing its value.

Investment committees/external review panels

- Investment committees/external review panels benefit from members with regional or local expertise who offer a more nuanced understanding of local markets.
- Panel members can be kept engaged with the fund by helping to restructure project proposals, and by playing a monitoring role beyond the awards phase.

Financial management

- Different mechanisms should be considered for funding different projects. Grants are not always flexible enough to meet the fund's goals: loans – particularly no-recourse, participating loans – can provide leverage over outcomes when they are repayable if specified outputs are not met.
- Fund disbursements should be in local currency, with the challenge fund absorbing the exchange rate risk.
- The main indicator of sustainability lies in the commercial viability of the business. If it is profitable, or likely to be so without challenge-fund support, the project is likely to be sustainable.

Monitoring and evaluation

- Reporting requirements should be simple so as not to overburden grantees.
- Reporting should focus on pre-agreed targets and outcomes, and reflect grantees' existing reporting practices.
- A web database system that tracks enquiries, appraisals, and the monitoring and management of different projects reduces paperwork and transaction costs for both grantees and fund managers.
- Fund managers should allocate due consideration – and budget – to the timely dissemination of the fund's results.

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