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Meeting the challenge: How can enterprise challenge funds be made to work better

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Meeting the challenge: how can enterprise challenge funds be made to work better?

Executive Summary

Enterprise challenge funds made a spectacular entrance onto the development landscape with early experiments providing direct support to the private sector in the late 1990s. In the past 15 years a number of donors – principally the Department for International Development (DFID), but also Australia's Department of Foreign Affairs and Trade (DFAT) and the Swedish International Development Agency (SIDA) – have spent about £850m on this aid modality. A large proportion of this spend has been disbursed through challenge funds in social sectors (such as the massive £355 million Girls Education Challenge) – but our focus here is the type of funds which have private sector grantees that are intended to create jobs and incomes.

Specifically, this topic guide seeks to explain:

- the evolution of challenge funds;
- the conceptual rationale for their use;
- their use in practice;
- findings on the effectiveness of challenge funds; and
- how the lessons learned should inform future challenge funds.

The first generation of DFID enterprise challenge funds in the late 1990s were designed to incentivise corporates to establish partnerships with DFID and leverage the corporates' own resources and local knowledge. A competitive and transparent selection process was adopted to ensure that only the best projects were funded. This also helped protect DFID from charges that it was favouring particular private sector firms with public grant funding. More recently, challenge funds have emphasised innovation and have sought a broader impact than just the individual businesses supported – through inclusive scale-up and replication. These objectives have become an important element of the rationale for using public funds to finance private sector organisations.

In practice, enterprise challenge funds have been used to support diverse projects in a wide variety of areas. Funds can be constructed in many different ways, including a varied focus on geography, sector, management style and the type of assistance provided. Some funds specialise on one geographical area (in some cases just one country), and others focus upon one or more sectors of the economy. The role of the fund manager varies considerably in terms of the intensity of involvement. It can take a "light touch" arrangement, restricted to marketing the fund, managing the selection process and managing the funds. Conversely it can also be much more intensive, such as providing guidance in the writing of applications, and technical support during project implementation. Grant funds can be provided as financial contribution, or be used to cover the expense of technical assistance. Most challenge funds are managed, for a fee, by private sector or NGO entities. To date almost all challenge funds have provided financial contributions matched with some form of financial or in-kind contribution from the grantee.

£850 MILLION

SPENT ON CHALLENGE FUNDS

Our assessment of the impact of challenge funds reveals the dearth of rigorous evaluation of the impact of this modality. In place of proper evaluation are a plethora of reviews which often do not take account of basic evaluation requirements such as an assessment of additionality, attribution or impacts (whether positive or negative) beyond the funded project. As such it is not possible to conclude with any confidence what has been the development impact of the public funds spent through challenge funds. However, there are recent and real signs that the assessment of impact is improving. In terms of monitoring the impact of challenge funds, the DCED Standard is introducing some rigour into the process. In addition, DFID is committing significant resources to the monitoring and evaluation (M&E) of challenge funds.

We conclude this topic guide with suggestions to improve the next generation of challenge funds. We suggest that challenge funds in the future should:

- Recognise that poorly designed funds can cause damage to local economies, and adopt a "do no harm" principle;
    - Significantly improve monitoring and evaluation of challenge funds, through:
    - considering the applicability of the DCED Standard to challenge funds, and in particular the nuanced application of the standard across a programme's portfolio; and
- selecting priority challenge funds where M&E resources can be best directed to conduct in-depth analyses and generate lessons. This could provide the foundations for a cluster evaluation that would improve understanding of the necessary context and conditions for successful challenge fund implementation, as well as draw comparisons with other aid modalities.
- Recognise that pushing fund manager fees below 20% of the grant value may be a false economy that could constrain the ability of funds to have catalytic effects;
- Consider a broader range of financing options than matching grants; and
- Not be used as a short-cut to good development practice and require strategic frameworks, plausible results chains, results chains and theories of change.

So it seems there are fewer reasons not to answer the fundamental question of whether, and how, challenge funds work. Before long, we may even be able to assess with some confidence how their performance compares to other approaches to stimulating private sector development.

> "We choose to go... not because [it is] easy, but because [it is] hard, because that goal will serve to measure and organize the best of our energies and skills, because that challenge is one that we are willing to accept, one we are unwilling to postpone, and one which we intend to win."
>
> John F Kennedy

MANAGEMENT FEES BELOW 20% OF THE GRANT VALUE MAY BE A FALSE ECONOMY

About the Authors

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Adam Brain is an Assistant Manager within Coffey's Economic Growth practice and has established and managed a variety of donor-funded enterprise challenge funds working in sub-Saharan Africa and Asia. Adam has recently advised on the establishment of Challenge Funds for DFID and the GSMA, which provide combinations of financial and technical assistance to private sector organisations in wholesale and retail, water and energy sectors.

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Jonathan Mitchell is the Practice Leader of Coffey's Economic Growth practice and has worked for over 20 years in private sector development in areas including market development, market linkages, value chain analysis and SME promotion. Prior to Joining Coffey, Jonathan was Head of the Private Sector and Markets team at the Overseas Development Institute.

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Abbreviations

AECF	Africa Enterprise Challenge Fund
ADB	Asian Development Bank
AusAID	Australian International Development
BLCF	Business Linkages Challenge Fund
CGAP	Consultative Group to Assist the Poor
CIDA	Canadian International Development Agency
DANIDA	Danish International Development Agency
DCED	Donor Committee on Enterprise Development
DFID	Department for International Development
ECF	Enterprise Challenge Fund
FDCF	Financial Deepening Challenge Fund
FRICH	Food Retail Industry Challenge Fund
GEC	Girls Education Challenge
GSMA	Groupe Speciale Mobile Association
IDB	Inter-American Development Bank
ILO	International Labour Organisation
M&E	Monitoring and Evaluation
MBRAM	Mohammed bin Rashid Al Maktoum
NGOs	Non-Governmental Organisations
PSD	Private Sector Development
SIDA	Swedish International Development Agency
USAID	United States Agency for International Development
WHO	World Health Organisation

1.0 Introduction

The challenge fund is a mechanism for the delivery of development assistance that emerged in the late 1990s. DFID, in particular, has led the use of challenge funds to partner with private businesses (enterprise challenge funds) and with civil society organisations and NGOs (such as through the Civil Society Challenge Fund; and the Girls Education Challenge).[1] There are clear signs that other donors are also showing an increasing interest in using challenge funds to deliver both public and private aid. Figures 1 and 2 highlight the rapid growth in the number and financial value of enterprise challenge funds.

This topic guide reviews the recent experience of challenge funding and examines the evidence of their impact and overall effectiveness. It also proposes the means by which additional future challenge funds can be strengthened in the future. Specifically, this topic guide seeks to explain:

- the evolution of challenge funds;
- the conceptual rationale for their use;
- their use in practice;
- findings on the effectiveness of challenge funds; and
- how the lessons learned should inform future challenge funds.

Figure 1: Activity levels of challenge funds (1999-2013)

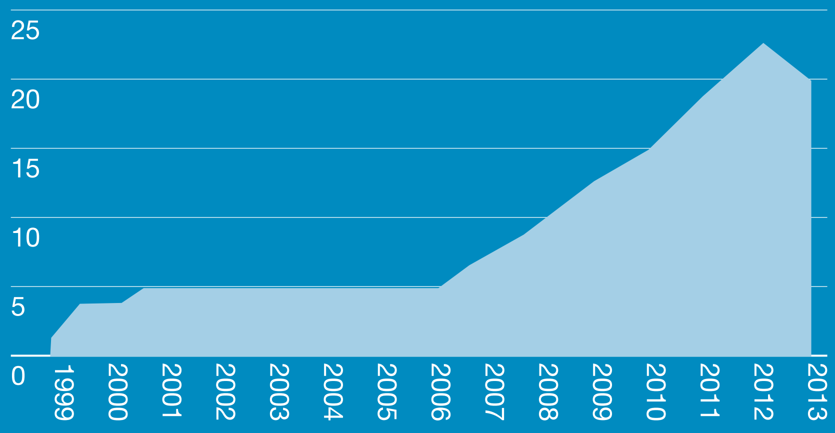
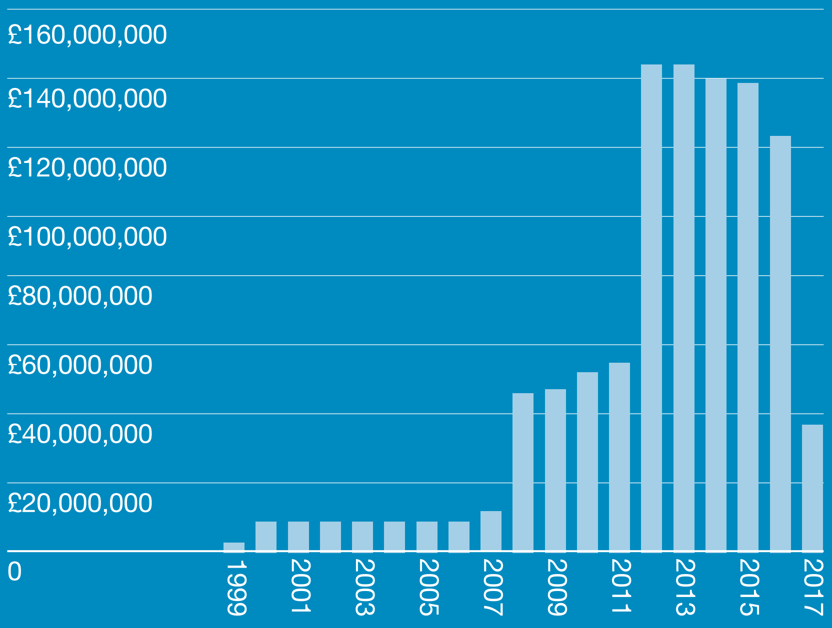


Figure 2: Funds disbursed through challenge funds (1999-2017)[2]



[1] A catalogue of challenge fund implementations is set out in Annex 2. This has been populated using project descriptions from donor websites and other challenge fund literature. The catalogue does not form an exhaustive list, and this guide acknowledges there may be additional examples that have not been included.

[2] Figures for 2014–2017 are based on confirmed timescales for current challenge funds. Past evidence shows that these are likely to be extended, which will result in a continued upward trend in spending.

1.1 Research methods

This review was undertaken as a desk exercise by Coffey International Development. This mainly involved reviewing secondary data, primarily in the form of practitioner, donor and "grey" reports on enterprise challenge funds. To strengthen the evidence base, this topic guide draws from the following additional sources:

- the limited academic literature available on donor engagement with private actors;
- telephone interviews with challenge fund managers;[3] and
- our own institutional experience of implementing some 15 challenge funds for a variety of funders since 1999, and evaluating relevant projects implemented by other organisations.

It should be acknowledged that very little of the evidence used in this topic guide has been subject to critical peer review. In fact, as much of the evidence generated by challenge funds is collected by the recipients of grant funding, there are a priori grounds for questioning the independence of these sources of data and analysis. The reason we made use of this relatively weak empirical base is the lack of a credible alternative. In this guide we highlight the strength of evidence available, and also data gaps remaining.

DRAWN FROM INSTITUTIONAL EXPERIENCE OF IMPLEMENTING 15 CHALLENGE FUNDS FOR A VARIETY OF FUNDERS SINCE 1999

1.2 Definitions

The most helpful definition of challenge funding can be found in a 2012 review of the challenge funds modality commissioned by SIDA.

> "A challenge fund is a financing mechanism to allocate donor funds for specific purposes using competition among organisations as the lead principle. A challenge fund invites proposals from companies, organisations and institutions working in a targeted field to submit project proposals. Challenge funds are always set up to meet specific objectives such as: extending financial services to poor people; finding solutions to a specific health problem in developing countries; as a means of triggering investment to certain high-risk markets; to stimulate innovation for effective use of water resources, etc. The scope of using challenge funds for creative problem-solving in development is very wide. Proposals are assessed against transparent and pre-determined criteria. Successful applicants must usually match a certain percentage of the grant with own financing. The challenge fund awards grants to those projects that best meet the objectives of the fund and fulfill various pre-established eligibility criteria."[4]

From this definition it can be seen that challenge funds offer a somewhat different approach to other forms of donor support[5] in that they are:

A competitive and transparent selection process: Unlike many other donor funding mechanisms, which appraise applications on their individual development potential and award grants on a discretionary basis, challenge funds implement a competitive and transparent selection mechanism – often the donor has only a minority vote in the grant-awarding process. Applications that are deemed to have best met the eligibility criteria are awarded funding.[6] Through this mechanism, applying organisations are incentivised into making applications as strong and innovative as possible to maximise their chances of receiving support.

Non-prescriptive: The nature of a challenge fund approach means that the fund manager outlines broad development and commercial eligibility criteria that supported projects are expected to meet. By doing this, as opposed to prescribing a specific approach to tackling a development challenge, it can result in innovative solutions being proposed that may leverage efficiencies from private actors.

[3] A list of interviewees is provided in Annex 4.

[4] SIDA (2012), "Guidelines: Challenge Funds. A guide based on SIDA's and other actors' work using challenge funds in development assistance/as a method for development."

[5] SIDA, Ibid.

[6] A standardised challenge fund selection process is set out in Annex 1.

Demand driven: All projects supported by challenge funds are solutions proposed by the implementing organisations, and proponents of challenge funds argue they are also likely to be practical, and may outline realistic and achievable project targets that the implementer is confident can be met.

Flexible support: Challenge funds are not limited to providing financial support to projects. Indeed, technical assistance has also been provided through competitive mechanisms as a standalone product, or as part of a combination of support services to private actors. The same can be said of challenge funds that target NGOs, where in addition to grant-funding organisations, there is also competition for the time of technical specialists to support project implementation.[7]

1.3 Challenge funds in development

The origins of the challenge funding methodology can be traced back to the 1700s, when the British government offered a reward of £20,000 to anyone who could develop a way of measuring a ship's longitude.[8] However, the use of transparent financial incentives by governments to encourage partnership initiatives in disadvantaged areas was only mainstreamed in the 1980s and 1990s.[9]

These proposals were then judged on a competitive basis at a national level, and grants awarded to the proposals that best met the judging criteria.[10] DFID's view was that these challenge funds in the UK had promoted

"innovation in the delivery of services and greater efficiency of resource use. The competitive process acts both as a spur for efficiency and for transparency of public resource allocation".[11]

Having invested significantly in various forms of enterprise development activities by the late 1990s, DFID wished to "develop new approaches to working in partnership with the private sector, which can play a key role in poverty eradication".[12] DFID explored the use of challenge funding in development through a number of challenge funds in the late 1990s, and is considered amongst its peers to have been "a pioneer in setting up challenge funds for development purposes".[13]

Although DFID has primarily used challenge funding as a transparent means of providing grant funding to businesses, DFID has also employed the mechanism on non-business-related themes. One early initiative was the Civil Society Challenge fund, and more recently the Girls Education Challenge (a fund of approximately £355 million). However, the focus of many DFID challenge funds and those of its donor partners have been business/market related. It is for this reason that enterprise challenge funds form the focus of this topic guide.

1.4 Initial focus on partnerships

At the outset, DFID's use of challenge funding had a focus on the formation of new partnerships, such as those between the private sector and NGOs, trade associations and government agencies. It recognised that this would require a "new way of working, both in terms of the process of bidding for funds and the working relationships needed between the 'partners'…which may not have had experience of working collaboratively".[14]

The wider policy context was supportive of this process with partnerships being a keystone of the 1997 White Paper on International Development. The White Paper stated that "There is a shared interest in a constructive approach between Government and business to support sustainable development" as a mechanism to achieve objectives. The aim was that partnership with business would "extend the range of skills and experience applied to objectives and in many cases leverage additional significant financial resources". In consultation with businesses in DFID's partner countries and some business groups in the UK, two business partnership challenge funds were established:

- The Financial Deepening Challenge Fund (FDCF); and
- The Business Linkages Challenge Fund (BLCF).

These challenge funds were intended both to help DFID achieve its objectives and to establish purposeful proactive partnerships between DFID and the private sector, from which DFID and business could learn lessons.[15]

Challenge funds can be traced back to the **1700s** when the British government offered a reward of £20,000 to anyone who could develop a way of measuring a ship's longitude.

[7] Civil Society Challenge Fund (2013) https://www.gov.uk/civil-society-challenge-fund

[8] Prize Funds are the earliest example of a mechanism that offers incentives to encourage innovation from public and private actors. See Bays, J. and Jansen, P. (2009), "Prizes: A Winning Strategy for Innovation", in What Matters.

[9] Hall, S. and Mawson, J. (1999), "Lessons for area regeneration from policy development in the 1990s".

[10] Ibid.

[11] DFID (1999), "Terms of Reference: Financial Deepening fund manager"

[12] Ibid.

[13] SIDA, op cit.

[14] Ibid.

[15] DFID (1999), "Terms of Reference: Business Linkages Challenge fund manager".

Recognising concerns about providing donor support to profit-making privately owned companies, the challenge funding methodology offered

> " a transparent and competitive process for business-led approaches to meeting poverty elimination objectives of mutual interest ".[16]

A key element of the challenge fund mechanism was the use of "competition to determine how public funds can be allocated to best effect".[17] The focus upon other aspects of challenge funding, such as innovation, has developed subsequently and primarily through the inputs of external reviewers.

Given the time-lag between the outputs of funded projects, and the projected impacts at beneficiary level, evaluations undertaken on completion of the FDCF[18] primarily focused on fund manager performance (in terms of costs of implementation and management efficiency) and the outputs of funded projects rather than the linkages between funded projects and development impact at beneficiary level. It was therefore on the basis of factors such as extended reach for financial services that the FDCF was seen as being both innovative and successful.

1.5 The evolution of challenge funds

Donors commissioned further challenge funds, including through the recommendation that Africa would benefit from its own private sector financing facility – the £125 million Africa Enterprise Challenge Fund (AECF).[19] The approach also drew the attention of other international donors, namely AusAID, which launched the Enterprise Challenge fund in 2007.

The FDCF and BLCF informed the design and implementation of following challenge funds such as the AusAID Enterprise Challenge Fund (ECF); and the Africa Enterprise Challenge Fund. Lessons learned from these challenge funds and recommended for adoption within subsequent challenge fund implementations include the following:[20]

- The role of the fund manager should be less "hands-off" disburser of grants, and more a "hands-on" investor of social venture capital.
- The purpose of any challenge fund should be to contribute to wider systemic (beyond project level) change.
- The "challenge" of challenge funds should be clearly defined, and informed by research, engagement and experience.
- Money should be seen as just one of the tools a fund manager has for engaging effectively with private firms.
- Larger firms represent stronger partners, with greater implementation capacity, and larger projects with larger firms tend to offer more potential for systemic impact.
- Firms should concentrate on delivering the commercial (private) objectives of the project. The fund manager should concentrate on ensuring the social (public) objectives of the fund are measurable and significant.

£125 MILLION

It was recommended that Africa would benefit from its own private sector financing facility – the £125 million Africa Enterprise Challenge Fund (AECF).

[16] DFID (1999b), "Terms of Reference: Financial Deepening fund manager".

[17] Ibid.

[18] OPM (2008), "Review of DFID's Financial Deepening Challenge Fund"; and Irwin, D. and Porteous, D. (2005),"Financial Deepening Challenge Fund Output to Purpose Review".

[19] Commission for Africa (2005), "Our Common Interest: Report of the Commission for Africa".

[20] Enterprise Challenge fund (2009) Mid Term Review; Business Linkages Challenge fund (2004) BLCF: Assessing Achievements and Future Directions Financial Deepening Challenge fund (2004) and; FDCF: Assessing its Achievements and Possible Future Directions

Table 1: Start and finish dates for a range of challenge funds

Challenge Fund	Donor	Start	Finish	Size of Grant Funds
Financial Deepening Challenge Fund	DFID	1999	2007	£18,500,000
Business Linkages Challenge Fund	DFID	2000	2008	£14,700,000
Innovations Against Poverty	SIDA	2010	2015	£3,906,000
ProPoor Innovation Challenge	CGAP	2000	2005	unknown
Civil Society Challenge Fund	DFID	2000	2015	£67,000,000
Africa Enterprise Challenge Fund	DFID, SIDA, AusAID, Netherlands Ministry of Development Cooperation, DANIDA	2008	2017	£125,000,000
Enterprise Challenge Fund	AusAID	2007	2013	£6,030,000
Food Retail Industry Challenge Fund	DFID	2007	2013	£7,100,000
Enterprise Innovation Challenge Fund	IDB, CIDA, DFID and Caribbean Development Bank	2012	2017	unknown
Grand Challenges Canada	CIDA	2008	2017	£123,825,000
COOP Africa Challenge Fund	ILO	2008	2013	£1,826,000
Grand Challenges Explorations Initiative	Bill and Melinda Gates Foundation	2008	2017	£60,900,000
Financial Education Fund	DFID	2009	2017	£2,500,000
Vietnam Market Participation Challenge Fund	DFID, ADB	2009	2015	£8,800,000
Sawaed Programme	MBRAM Foundation	2009	2014	unknown
Business Innovation Facility	DFID	2010	2013	£3,000,000
Responsible and Accountable Garment Sector Challenge Fund	DFID	2010	2013	£2,900,000
Development Innovation Ventures	USAID	2010	2015	£18,865,000
Girls Education Challenge	DFID	2012	2016	£355,000,000
Grand Challenges for Development Initiative	USAID	2011	2015	£15,214,000
Afghanistan Business Innovation Fund	DFID	2011	2016	£2,500,000
Construction Ideas Fund	DFID	2012	2013	£2,500,000
Mobile Money for the Unbanked (MMU) Fund	GSMA (Bill and Melinda Gates Foundation)	2009	2012	£7,500,000
mFarmer Initiative Challenge Fund	GSMA (Bill and Melinda Gates Foundation and USAID)	2011	2014	£1,200,000
mWomen Innovation Fund	GSMA (AusAID and USAID)	2012	2015	£1,500,000
Mobile Enabled Community Services (MECS) Innovation Fund	GSMA (DFID)	2013	2014	£2,200,000
Total				**£852,466,000**

2.0 Conceptual basis for challenge funds

2.1 A tool for financing innovation

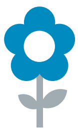
The rationale for challenge funds has, over time, become increasingly linked to the financing of innovation, which is viewed as an area of significant potential for solving development challenges.[21] Where funding gaps exist, challenge funds may play a role by ensuring (through competitive processes) that innovations with the highest potential to provide development benefits receive grant support. However, challenge funds must distinguish between innovations that are likely to reach the market of their own accord so as to maximise the effectiveness of donor spending.

Financing and technical assistance is crucial for early stage innovations, as the costs involved with bringing the innovation to market are likely to be beyond the financial capacity of many early stage businesses and their owners. Examples of these costs can include: research and development, product conception; prototype development, market definition and testing; and initial production, shipping and marketing.[22]

Based on these development milestones and financing needs, several financing stages can be distinguished, each characterised by its specific amount and use of financial resources:[23]

The seed stage covers the initial research and development of a commercial idea or business concept, focused on determining its technical feasibility, market potential and economic viability.

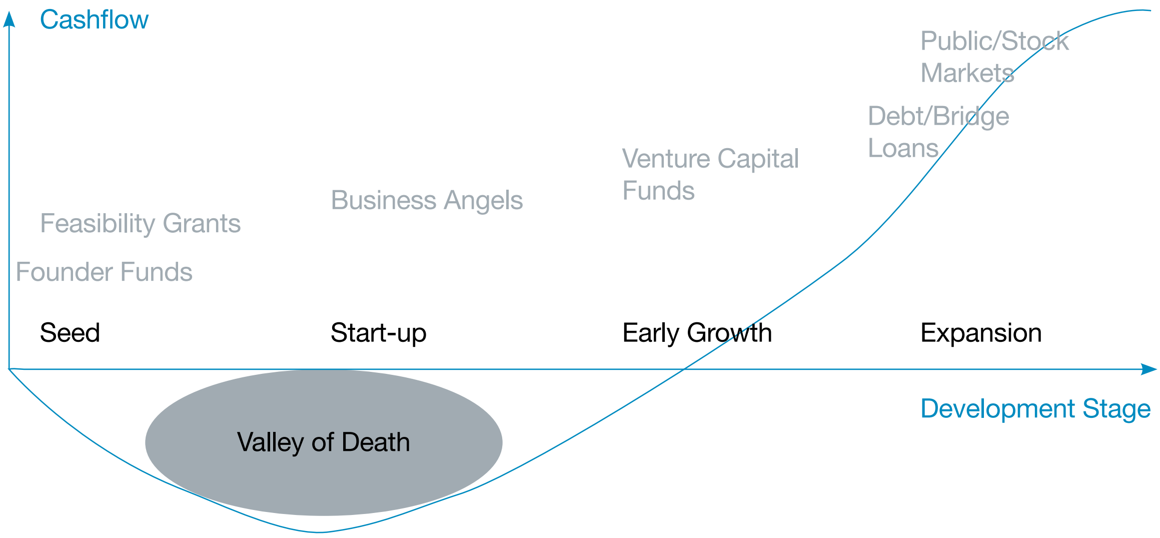
The start-up stage covers the development of a product prototype; initial market research and marketreach activities, and the establishment of a formal business organisation.



The early-growth stage pertains to small-scale commercialisation and growth, as well as to the development of the pillars for the scalability of the business.

The expansion stage covers the substantial growth in the scale and market impact of the business.

Figure 3: Development stages, cash flow and sources of finance[24]



[21] DFID (2012) Promoting innovation and evidence-based approaches to building resilience and responding to humanitarian crises: A DFID Strategy Paper

[22] Hall, B. H., and Lerner, J. (2009), The Financing of R&D and Innovation.

[23] United Nations (2009), "Policy options and Instruments for Financing Innovation: A Practical Guide to Early-Stage Financing".

[24] Ibid.

Summarising innovation literature

Traditional models of innovation theory outline that innovation is a linear process of scientific discovery resulting in technology which satisfies market needs. It conceives of commercial research and development as applied science and envisions a smooth, uni-directional flow from basic scientific research to commercial applications.[25]

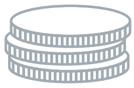
However, more recent literatures claim that external support or intervention may be required to ensure that promising innovations can progress to full commercial application.[26] Support may be required for the following reasons:

- There is a degree of uncertainty over the outputs of innovative projects, as the scope and focus of the project is likely to change throughout implementation.
- Where the focus of innovative projects remains consistent to the terms of investment there are also risks related to the market uptake of project outputs and whether this will generate a sufficient return on investment for financing organisations.

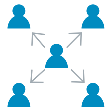
A high proportion of costs for innovative activities are related to R&D, and more specifically the wages and salaries of highly educated professionals that bring tacit knowledge to projects. This human capital is highly mobile and represents a high risk to financing organisations should individuals leave the project.

2.2 Support to inclusive business

Challenge funds have been also been referred to as instruments to support "inclusive business" activities.[27] The literature on inclusive business offers many different definitions of the concept. However there is consensus that inclusive business entails creating a net positive development impact through a financially profitable business model. The key rationale for challenge funds is to incentivise inclusive business, and there is evidence in the literature of four types of inclusive business models, which are also explained further in the diagram below: [28]

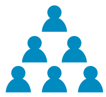


selling products and services that are needed by the poor and have a high development impact;



large companies take deliberate action to expand development impacts through supply and distribution chains or R&D;

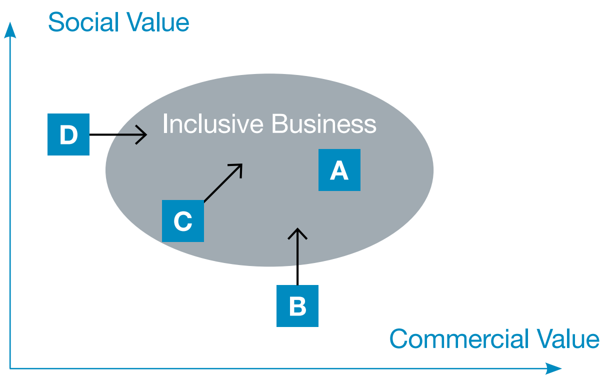
domestic small and medium enterprises that have local economic development as an explicit driver because they are embedded in the local economy; and



social enterprises whose core product is of high social value.

Challenge funds offer a competitively allocated supply-side subsidy to inclusive businesses, with the logic behind these subsidies being to increase the supply of goods and services that provide positive development externalities.

Figure 4: How challenge funds incentivise private actors into participating in inclusive business activities [29]



Example A:
Mobile phones and banking services appropriate for poor people

Example B:
Oil/gas/mining company supporting SME development via the supply chain

Example C:
Domestic leisure firm prioritising labour-intensive entertainment and local staff training

Example D:
Provision of essential drugs and basic health services via a micro franchising distribution model set up by a non-profit organisation

[25] Edquist, C. and Hommen, L. (1999), "Systems of innovation: theory and policy for the demand side", in Technology in Society, 21:1, pp. 63–79

[26] Hall, B. (2005), "The Financing of Innovation", in Oxford Review of Economic Policy.

[27] Ashley, C. (2009), "Harnessing Core Business for Development Impact: Evolving Ideas and Issues for Action".

[28] Ibid.

[29] Ibid.

2.3 Challenge funds and systemic change

Market-related development involves understanding complex market systems. Systems thinking should be incorporated into the diagnosis of market systems and developing interventions in order to achieve "systemic impact" (when a development intervention results in the wider market system, or players in the market, responding, or changing behaviour, leading to additional development impact).[30] A debate has emerged focusing on whether challenge funds can support the establishment of innovations that create favourable systemic change.

Challenge funds have also been criticised for focusing heavily on expanding the size and scale of innovative activities with high pro-poor potential, without clearly understanding the wider behavioural impacts on the market system as a whole of the introduction of such an innovation.[31]

> "Unless it [behavioral additionality] is taken seriously, and unless it's realised in practice, challenge grants cannot be deemed 'transformational' but, rather, national governments would need to adopt a more permanent public good funding focus to innovation. From a review of wider experience, only one evaluation globally was found to have considered this issue explicitly and concluded that grants (alone and discrete) did not realise any behavioral additionality (i.e. they have not proven transformational)." [32]

Conceptually, there is no reason why challenge funds cannot have systemic impact. Provided fund managers have:

- conducted sufficient market systems analysis to identify systemic constraints;
- approved projects which are able to overcome these constraints; and
- shared success stories with other firms struggling with the same constraint.

There is no reason why the immediate and direct impacts of challenge funding cannot be replicated along supply chains and throughout local economies. In practice, this longer-term goal of achieving systemic change has often been under-prioritised compared with the pressure to disburse funds to suitable grantees and achieve immediate performance targets from directly funded projects.

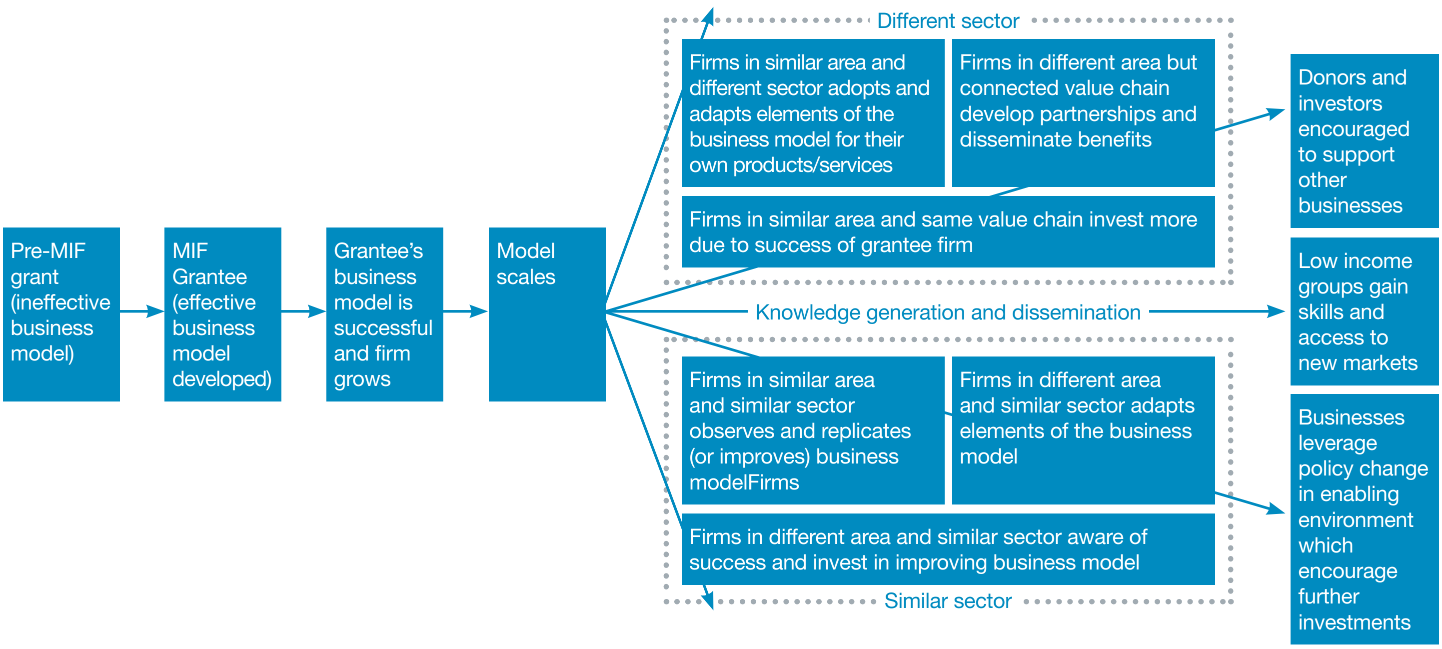
The conclusion is that more time should be invested by practitioners in understanding market systems before considering whether a challenge fund provides the best solution. Provided that firm evidence is identified of an underlying constraint, and that grant finance is a suitable tool, there is no reason why a challenge fund cannot result in wider actors in the market system changing their behaviour.

[30] Taylor, B. (2013), Evidence-Based Policy and Systemic Change: Conflicting Trends?, The Springfield Centre.

[31] Elliott (2013) "Exploding the myth of Challenge funds – a start at least" The Springfield Centre

[32] Elliott (2013) "Exploding the myth of Challenge funds – a start at least" The Springfield Centre

Figure 5: A graphical illustration of how a single challenge fund grant can stimulate systemic change



3.0 Practical Application

This section distils the key issues arising from the 27 enterprise challenge funds in Table 1 over the past decade and, together with a literature review and practitioner interviews, highlights practical considerations in their implementation.[33]

The first and most obvious point is the striking heterogeneity amongst this single category of aid modality. Our sample includes challenge funds which have been supported by donors from different bilateral programmes and, more recently, the private sector.

3.1 Breadth versus depth

Challenge funds have adopted a variety of approaches – from small, specialised challenge funds focusing on a single country (or even a single sector in a single country), to a narrow theme (garments industry or supermarkets), to large-scale challenge funds with broad purposes and several funding windows.[34] The extent of geographical and sector specificity is well illustrated by AusAID's Enterprise Challenge fund, which targeted nine countries in the Asia Pacific. DFID challenge funds have tended to have a stronger sectoral than geographical specialisation: Business Linkages Challenge Fund (BLCF), Africa Enterprise Challenge Fund (AECF), Financial Deepening Challenge Fund (FDCF) and the Food Retail Industry Challenge Funds (FRICH).

The key rationale for keeping challenge funds as broad as possible is to maximise the number of eligible grantees, and so encourage stronger competition and private sector innovation and increase the likelihood of fund resources being fully utilised.

> “ Enterprise challenge funds should aim to promote private sector innovation wherever it might be found, rather than limiting their scope to narrow geographic regions or individual sectors of the economy ”.[35]

There are empirical grounds for this viewpoint. For instance, too narrow a focus – compounded by weak project design – resulted in an insufficient quality of applications, which led to the premature closure of the BLCF in Ghana.[36]

The perils of narrow targeting of challenge funds[37]

The AECF operates from regional hubs in Nairobi, Johannesburg and Accra and is active in 23 African countries and has country-specific windows, focusing on agricultural processing and financial services – for which any African country is eligible (multi-country or regional projects are also eligible).

A recent Annual Review of the Zimbabwe window of the AECF, noting the rather sharp reduction in the quality and size of recent applications to the fund, concluded that the first two rounds of funding had already selected most of the larger and more straightforward projects eligible in Zimbabwe and compatible with the AECF-Z.

[33] The full catalogue of challenge fund implementations is available in Annex 2.

[34] SIDA, op cit.

[35] Callan, M., and Davies, R. (2013), When business meets aid: analysing public–private partnerships for international development. Australian National University.

[36] Elliott, D. (2004), DFID Ghana Business Linkages Challenge Fund (G-BLCF) Project, Ghana, Output-to-Purpose Review. The Springfield Centre.

[37] Source: Coffey International Development (2013), “Annual Review of Pro-Poor Growth Programme in Zimbabwe”.

There is a counter view, in support of increased geographical or sector specialisation ("or" rather than "and" because specialisation in either one of these two dimensions tends to weaken the case for specialisation in the other). This is based on the rationale that targeted challenge funds allow the fund managers to develop a deeper local or sectoral understanding of the context from which proposals have been generated. This knowledge should allow fund managers to assess the quality of individual proposals more effectively. Importantly, a thorough understanding of specific market systems also should allow fund managers to better identify individual projects which, if approved, may have more significant replication, scale-up or systemic effects.

In short, it is important challenge funds are neither so narrow and specific that innovative new ideas are excluded, nor so broad that the projects collectively fail to trigger any systemic change in their sub-sector. As Heinrich has suggested, a more targeted approach can support a critical mass of projects in sector or geographical area. This critical mass of activity can stimulate the "crowding in" effect, which can create a cumulative challenge fund impact that is more than the sum of the projects that have been directly funded.

3.2 Role and cost of the fund manager

As suggested earlier, the role of fund manager can be described as "light touch", or more intensive across two different dimensions. The first is the type of market actor that the challenge fund will fund.

You may have a challenge fund focused on one particular group of actors (e.g. private actors only) or a fund that allows funding to a broader range (e.g. private, governmental and/or civil society). There are pros and cons to these different approaches.

A "light touch" approach describes the arrangement (not uncommon for challenge funds) where the fund management focus their engagement with private sector partners. An approach which confines itself to private sector partners, and even more restrictive than this to private sector partners seeking funding from the challenge fund, is less difficult and cheaper to manage.

An alternative role for the fund manager is to involve and, in some cases, fund government organisations, regulatory agencies and business associations. This more holistic partnership arrangement may also be associated with a more "hands on" developmental approach to fund management, which looks beyond the selection of financially viable projects that offer significant development impact. While this approach does have the potential to scale-up the development impact of a challenge fund, it also demands a more "hands on", and expensive, model of fund management. This may require management fees to increase to 30% of the grant disbursed, or more.

The second dimension of the role of the fund manager involves the **actual scope of activities undertaken**.

At the "light touch" end of the spectrum, the role of the fund manager is limited to promoting the existence of the challenge fund, selecting appropriate projects and monitoring the use of the fund. The very practical benefit of this is that the management fee for fund management service will often be lower and will tend to focus upon the management of the fund. Management fees of about 20% of the grant funds disbursed over the lifetime of the challenge fund – in some cases up to six years, so just over 3% per year – are viable for this form of "light touch" management.

At the other end of the spectrum, fund managers may be very much more engaged and be responsible for market system assessments, trying to stimulate broader changes in the market system, in addition to supporting the individual projects of selected grantees. The fund manager may also support grantees from weaker organisations with technical and project implementation support. There are sound development reasons for adopting a more engaged fund manager role. However, this heavier role is more expensive and will typically cost 30% or more of grant disbursed. As illustrated, there are clear pros and cons of adopting a "light touch", or a more engaged fund manager role across both of these dimensions – and the choices made are a fundamental aspect of challenge fund design.

30%

A hands on approach to fund management is more expensive and will typically cost 30% of grants disbursed or more

Donors use both "light touch" approaches that use financial incentives to spur private sector entrepreneurship, and more engaged approaches that seek to address capacity and information deficits, coordination failures and often provide or facilitate financing. Trying to distil a general trend is difficult, but there is some evidence that the pendulum has swung from "light touch" with the early challenge funds (to maximise impact and justify the use of this aid modality), to "hands-on" (to improve the developmental impact of challenge funds) – and back again to "light touch", driven principally by value-for-money considerations.[38]

An interesting recent trend has been for DFID to embed a challenge fund within a market development programme. This has been a feature of the Growth and Employment in States programmes in Nigeria, for instance. This arrangement should allow funds to benefit from existing knowledge of market systems which has already been generated by the non-challenge fund element of the programme.

3.3 Size of the grant

The appropriate scale of challenge funds, both in terms of the individual grant (or loan) size and also the scale of the initiative as a whole, varies widely.

The first generation of challenge funds were designed on the premise that large grants to larger enterprises would lead to higher level of efficiency and impact. In terms of efficiency, this hypothesis largely holds – provided potential grantees have the capacity to absorb the scale of funding available. It is often as expensive to administer smaller grants as compared with larger grants – particularly if the former are to organisations which require significant support from the fund manager. In addition to efficiency, there are plausible grounds for expecting larger grants to stronger organisations to achieve large-scale or systemic development impacts, and much more significant counterpart contributions to match aid grants.[39]

However, smaller grants to less-established firms generally demonstrate much clearer additionality. This is a critical justification for the use of public aid for private organisations. In addition, the political sustainability (both in the donor and recipient countries) for enterprise challenge funds rests on their support for local enterprise development. Challenge funds are likely to be scrutinised vigorously if they are perceived to bypass indigenous enterprise and restrict themselves to risk reduction services for multinational corporations.[40]

3.4 Attitude to risk

As outlined in the introduction, risk is not just an inherent feature of challenge funding – it is also a fundamental requirement to justify the application of public funds to private corporate entities. A grantee with a financially and developmentally viable investment that has a low-risk profile should be able to raise investment finance from existing capital markets. Using challenge funds in this context would risk investments in projects with poor additionality and have potentially market-distorting effects.

As a consequence, the generally held view is that, as risk capital, challenge funds should not attempt to totally avoid risk. A portfolio approach can be used to mitigate the risk to the whole fund of any individual project failing. In fact, attempting to avoid risk at the level of individual project selection raises the danger of challenge funds using public aid trying to "pick winners" (i.e. support projects that would probably have happened without public support and, therefore, demonstrate weak additionality). In addition, "picking winners" raises the danger of "crowding out" of competitors in the sector by conferring an unfair advantage on one particular firm. Under the guise of market development, the risk of actually generating competitive asymmetries – where particular firms are given privileged access to finance and other support – is difficult to defend as a legitimate use of public aid.

[38] Development Policy Centre (2013), Working Group on Enterprise Challenge funds background papers for the second and third meetings, Australian National University.

[39] Heinrich, M. (2013), Donor partnerships with Business for Private Sector Development: What can we Learn from Experience?, DCED.

[40] Development Policy Centre, op cit.

These pressures have created complicated countervailing pressures for challenge fund managers. On the one hand fund managers are under pressure from their donors to demonstrate rapid and significant impact, keep the proportion of project failures to reasonable levels and minimise the management costs of challenge funds. On the other hand, an aid modality designed to transparently select the best project against a range of commercial and development criteria should, on market development criteria, be able to defend itself against the charge of "picking winners".

There is clear tension between the pressure to deliver results and value-for-money but also to deliver public aid in a way that can be justified on market-development principles. Some challenge funds have sought to justify their approach as not "picking winners" but rather "starting races". As is suggested later, to deliver on this claim may require a revision of the financing modalities of challenge funds.

3.5 Who manages the challenge fund?

Our sample of enterprise challenge funds illustrates that it is common practice for donors to outsource management of enterprise challenge funds to external companies – and almost always to private sector development consultancies. Underlying this is a belief that private sector consultancies and, occasionally international NGOs, are better suited to run private sector development programmes than public organisations. Interestingly, the authors of this guide were unable to find any evidence to support (or refute) this belief.

3.6 Decentralisation

Some challenge funds have a decentralised structure. This allows fund management to gain context specific knowledge, have closer contact with beneficiaries and integrate more closely with other donor initiatives.

Conversely, centrally managed facilities have the potential to generate and share knowledge and market the fund to a wider range of business partners. There is a trend for centralised challenge funds to develop into consolidated, multi-donor programmes such as the AECF, which has fund resources of some £200m sourced from a range of bilateral agencies. These consolidated funds should be able to offer a scale, efficiency, visibility and impact which are greater than smaller, isolated challenge funds. These consolidated funds also offer donors some mutual reassurance that the use of public subsidies to private sector actors is a justifiable use of aid, and some protection against charges of bias in the selection of grantees.

3.7 Financing options

The extent to which technical expertise is offered varies across different challenge funds. In some cases challenge funds mainly (or in the case of the Business Innovation Facility, exclusively) offer technical support to businesses. More often a blend of technical and financial support is offered with an emphasis on financial support.

Most challenge funds use matching grants to businesses. The grant is "matching" because the grant award from the challenge fund is conditional upon leveraging at least a similar magnitude of funding from the grantee organisation (normally in the form of finance, but sometimes as "in kind" contributions[41]). This is the mechanism used to share risk between the challenge fund and grantee and ensure grantee ownership of the project.

Leverage ratios are often one of the key indicators of success by challenge funds. Typical leverage ratios for challenge funds vary from 1:1 (meaning each £1 of grant levers the same quantity of external funds) to 1:4. The achievement of high leverage ratios allows fund promoters to claim, with justification, that the challenge fund is incentivising private sector investment and is generating an impact which is a multiple of the outlay of aid funds.

[41] Elliott, D. op cit.

Leverage ratios are a useful part of the justification for applying public subsidies to the private sector. The danger of having too strong a focus on leverage ratios is that it may encourage fund managers to be too risk averse and choose well-capitalised grantees for which the additionality of the challenge fund and non-distortionary impact of aid is most difficult to demonstrate. The matching fund requirements of challenge funds can, paradoxically, create a barrier to entry for the firms which are most in need of grant finance.

The use of grant finance for most challenge funds is based on a range of arguments from the pragmatic to the conceptual. Administering grants is much easier, and therefore cheaper, than loan, equity or quasi-equity financial instruments. From a public aid perspective there is, strangely enough, a value-for-money driver incentivising donors to give money away for free to businesses. Using grant finance rather than loans also allows challenge fund promoters to claim that they are not competing with banks, and therefore not distorting markets. The weakness of these justifications for the use of grant for challenge funds has caused some donors and practitioners to consider the application of a broader range of financial instrument options.

The AECF offers a mix of grants and loans to grantees, and a blend of the two in non-recourse grants/loans. The logic of this approach is robust, namely that firms which have received aid funding and have successfully generated a healthy financial return should return a proportion of the subsidised finance they have received. This logic should be balanced against the perverse incentives generated by a challenge fund where success is penalised with a higher cost of capital.

Some donor agencies are considering a range of financing options and complementing grants with loans, guarantees or equity (often with an element of subsidy) rather than providing pure grant support alone.[42] This is an encouraging development, and indicates that development practitioners are starting to consider the different financing needs of diverse grantees as well as the requirements of donor organisations in the design of challenge fund instruments. These innovative design concepts do, however, present significant management and resultsmeasurement implications for many public donor organisations. If adopted, donor organisations will need to develop longer time horizons and a more nuanced range of criteria by which to assess the results of challenge funds, to accommodate these financing options.

A more radical approach is to question whether challenge funds should pay for inputs or results. Typically, enterprise challenge funds approve a project proposal for a specific business and a subsidy is paid to get the project implemented. Generally the level of subsidy is fairly fixed – irrespective of the impacts achieved by the funding. This arrangement does not completely align the incentives of the funder and the grantee. It also implies that the funder carries most of the risk for failure to deliver project results.

An alternative approach is to reward businesses ex-post for having already achieved specified development impacts. The advantage of this approach is that the challenge fund will only disburse if impact is demonstrated – so the risk of innovation not working is carried by the potential grantee. The incentive effect of this results-based approach could stimulate innovation amongst a group of companies rather than just privileging a single grantee business. In a true sense this approach would be "starting races" with real competitive neutrality, rather than "picking winners". Under the scenario of results-based aid, the distinction between challenge funds and prize funds melts away – because both require entrepreneurs to invest at their own risk and only receive compensation if the investment achieves the desired outcomes.

A legitimate concern with this results-based aid approach is that businesses need to have up-front financing capacity to implement the initiative (for which they will only receive ex-post funding if results are achieved). But many companies which otherwise respond to challenge funds do not have this finance available. Such an approach would also require the funding agency to know in advance what results is being aimed for, and the likely costs of achieving these results.

LEVERAGE RATIOS

range from

1:1

Meaning each £1 of grant levers the same quantity of external funds

1:4

[42] Development Policy Centre (2013), Working Group on Enterprise Challenge Funds background papers for the second and third meetings, Australian National University.

In summary, challenge funds are an extremely diverse category of aid modality. The design of challenge funds can vary across a broad range of dimensions and choices made during design will determine the development objective which the fund is able to deliver. The evidence reviewed does not suggest that there is a "correct" blueprint for challenge fund design – the appropriate choice will depend upon what is the objective and context of the fund itself. Funds vary in terms of:

- the geographical and sectoral focus of the fund – from specialist challenge funds focusing on a single sector in a single country, where fund managers have significant context and sector knowledge – to very broad funding windows with fewer restrictions on eligible applicants;
- the role of fund manager varies between a "light touch" and less expensive approach focusing almost
- entirely on private sector grantees and a narrow range of activities, to a more holistic approach that
- engages with a broad range of potential grantees and offers a wide range of services to grantees;
- the size of fund disbursements, from very large disbursements to relatively established businesses with high leverage ratios and strong institutional capacity (but sometimes with questionable additionality), to smaller disbursements with weaker firms but often higher additionality;
- balancing project risk between relatively low-risk projects with institutionally strong grantees and more secure results but the potential danger of funding "crowding out" commercial funding sources, and generating competitive asymmetries. On the other hand more risky investments are less likely to secure funding from elsewhere but are more risky to administer and manage;
- decentralised challenge fund structures will generally have a richer knowledge of the local context and the grantee – but will be less able than centralised fund structures to realise economies of scale and share
- knowledge between a range of different places; and
- the simplicity of grant management should be traded off against the potential distortions created by subsidies, and the concentration of risk of projects failing to deliver results with the challenge fund financier. Conversely, more complex financial instruments with a lower level of subsidy offer an attractive alternative to the standard matching grant product – but are more difficult to manage and may present insurmountable barriers to entry for less-established potential grantees.

4.0 Assessment of Impact

4.1 Quality of evidence

Most evaluations of challenge funds focus on relatively easy-to-measure indicators, which are fairly low along the results chain – such as leverage ratios and the outreach of funds and their impact on the commercial viability of grantee businesses. These are useful indicators of the extent to which challenge funds have stimulated private sector investment, engaged with businesses and generated profitability and gross jobs. Only recently have donors articulated the clear need to understand the higher-level outcomes and impacts of enterprise challenge funds (propoor net jobs and incomes). This need for robust evidence on the development outcomes of funds is demonstrated by the investment DFID is making in monitoring and independent evaluation of challenge funds. Notwithstanding the huge volume of monitoring and evaluation reports generated since the late 1990s, we are still unable to assess whether challenge funds are, in addition to being good for business, good for development. This is because most monitoring and evaluation exercises focus too low down the results chain and, even those that do try to measure development impacts, generally fail to do so with sufficient rigour.

The most confident review of impacts of challenge funds can be found in the 2012 SIDA guide. In it, a positive overall assessment is proposed, on the basis that most of the funded projects are reported to be achieving stated objectives. Additionality, in the sense that challenge funds are achieving development outcomes which otherwise would not have occurred, also appear to be satisfactory. The SIDA review does, however, acknowledge the paucity of evidence on the systemic development impact of challenge funds.

Others are more circumspect.[43] They suggest that it remains plausible that, for certain types of investment, a oneoff injection of aid funds without much other engagement could deliver, across a portfolio of activities, development results substantial enough to dwarf the costs of any failed activities. In other words, that challenge funds may have a positive net effect.

While hardly ringing endorsements, most other reviews on the effectiveness of challenge funds are more sanguine. Interestingly, the discussion focuses less upon whether challenge funds are effective or not, and more on whether we have sufficient evidence to even address the question.

Challenge funds and the paucity of evidence at outcome and impact level

In her survey of public–private partnerships with business for private sector development for the Donor Committee for Enterprise development, Heinrich notes that 'we know relatively little about the results achieved, and in particular, their development impacts' (2013).

Despite the significant funding provided to challenge funds, there is currently little evidence to show whether they achieve the anticipated development impacts (Kessler 2013).

Despite the very substantial resources spent through such mechanisms, there is very little evidence that subsidies spur firms to undertake innovative activities that they otherwise would not have undertaken (Campos 2013).

4.2 Evaluation

Given the fact that DFID has sponsored at least 14 challenge funds and each one is subject to a plethora of reviews (annual reviews, mid-term reviews and project completion reviews), it may seem counter-intuitive to suggest there is a lack of reliable evidence. However, this is indeed the case. While there are a large number of reports monitoring and reviewing challenge funds, there are very few evaluations that are sufficiently robust to generate evidence of a quality that allows us to draw conclusions about the key issues identified in the previous section (i.e. additionality, competitive asymmetry, systemic change, development outcomes, etc.) with confidence.

[43] Callan, M. and Davies, R., op cit.

Part of the reason for this lack of rigorous evaluation is that it is expensive. The cost of thorough M&E for DFID's largest challenge fund – the £300m Girls Education Challenge – is about 5% of total grant disbursements.

This situation is, however, changing rapidly for the better. DFID is increasingly appointing independent evaluators at the beginning of programme implementation. Evaluation is also beginning to receive the magnitude of funding required to undertake robust evaluations. It will take time for the outputs of these evaluations of the current pipeline of on-going projects to emerge but they will generate evidence that is sufficiently robust to allow us to thoroughly assess the impact of aid across a broad range of modalities.

There is also potential for fund managers to aid evaluators in understanding challenge fund impacts through designing monitoring systems which prioritise scarce M&E around grants delivering greater results.

Cost-effective monitoring: Finding the bright spots in the AECF

In a recent review of the results-measurement system of the Africa Enterprise Challenge Fund (AECF)[44], pragmatic proposals were made for a tiered approach to measuring results. In common with most challenge funds, about 80% of total AECF results are delivered by one-third of the total of 200 funded projects. For these projects, it is proposed to undertake a beneficiary model based upon a poverty assessment and clear results chain, an independent baseline and verification study and twice annual visits from the fund manager to verify that the monitoring system is accurately capturing development impact.

This approach is obviously resource intensive – so the projects which fail to deliver results, or deliver much more modest results will be monitored much less intensively. This is an innovative approach aiming to improve results measurement without being hugely expensive in either donor M&E costs or business disruption.

Girls Education Challenge, Department for International Development

A recent movement towards addressing the evidence gap for challenge fund impact is the evaluation of the GEC, DFID's largest challenge fund which implements across 16 countries and 40 projects. This three-year project is using innovative evaluation techniques, including experimental, quasi-experimental and theory-based designs to evaluate the impact, effectiveness and value for money of each funding window and the programme as a whole. The GEC offers:

Independence
The multi-country evaluation is overseen by an evaluation manager who maintains an independent, impartial and objective role in delivering research, management and reporting responsibilities required of the function.[45] While there are clear benefits to taking a collaborative approach to evaluation at project and programme levels, the evaluation manager is committed to ensuring that the objectivity and impartiality of the programme evaluation is not compromised by this approach.

Assessments of attribution
All projects are encouraged to establish a counterfactual through the identification of control or comparison groups, either in the form of schools or communities that have not been exposed to the project's activities. In exceptional cases where a project is unable to establish a counterfactual position for impact evaluation purposes, an alternative evaluation design is developed to ensure that the research undertaken is as rigorous as possible given the project's circumstances.

Assessments of additionality
The approach to evaluating the aggregate impact of the GEC programme involves a combination of three analytical techniques:

- Aggregated project impact evaluation (and where possible systematic review of the size and type of effects) using impact evaluation evidence externally commissioned by grantees and quality assured by the fund manager and evaluation manager.
- Meta-analysis (statistical analysis) of programme impacts and cross-cutting thematic analysis using project-level data (subject to the availability of good-quality raw data) to evaluate project effects (impacts) and effectiveness in different contexts.
- Thematic studies using quantitative and qualitative primary research conducted by the evaluation manager to identify what works in a particular contexts with regards to a variety of mechanisms for change.

[45] The Evaluation of the Girls Education Challenge Fund is managed by Coffey International Development on behalf of DFID.

[44] The review was conducted by Coffey International Development on behalf of the AECF

It has been recommended that the first step in improving future design for inclusive business approaches should be multi-donor, multi-programme evaluation of current and past approaches – with specific consideration of the advantages and disadvantages of enterprise challenge funds compared with other approach, for instance valuechain initiatives.[46] The advantage of this proposal is that it would generate evidence more rapidly than having to wait for current projects to be implemented and evaluated from the start. The disadvantage with this form of recallbased exercise is that the project-level information on which it would rely may be insufficiently robust to meet the definition of an evaluation. This would be, in effect, a meta review of challenge funds and other approaches – rather than an evaluation.

4.3 Assessment of current practice

Any analysis of current practice requires a benchmark against which we can assess performance. Fortunately the DCED standard provides a plausible, if not universally accepted, framework. This standard was designed to enable the impact of private sector development projects to be assessed (not evaluated) internally. It provides a framework for monitoring and measuring results. The DCED standard has recently been applied to a number of challenge funds[47] including the Enterprise Challenge Fund and the AECF.

4.4 Donor Committee for Enterprise Development (DCED) Standard

The DCED standard aims to provide a practical toolkit for private sector development practitioners to monitor the progress of private sector development programmes towards objectives. The standard comprises an 8-step approach to capturing results, which can be integrated into challenge fund management (see Annex 3).

Drawing on the above standard, a recent DCED study[48] has looked to integrate these principles into a practical set of recommendations for improving the M&E of impact from challenge funds. The recommendations here refer specifically to the private sector, but could also be implemented for civil society challenge funds:

1. **Developing a clear results-measurement system from the beginning**
   By making results-measurement responsibilities clear from the start, key requirements – for example providing specific data against indicators, and agreeing to host project visits – can be made into a contractual requirement for the grantee.

2. **Ensuring results measurement provides mutual benefits for the business**
   Indicators can be generated that inform both the results-measurement system of the fund, and also allow the business to keep track of their commercial performance.

3. **Taking a portfolio approach to monitoring and evaluation**
   Many challenge funds have supported both successful and unsuccessful projects, and lesson-learning on why some projects have failed is an important step in improving best-practice. In order to best utilise limited resources, fund managers should be given the freedom to monitor some projects in more depth than others based on criteria such as cost, success or the degree of innovation. An example framework for prioritising projects that require more rigorous monitoring and evaluation is set out in Table 2:

[46] Callan, M. and Davies, R., op cit.

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

[48] DCED (2013b), Guidance on how to use the DCED Standard to measure results in Challenge Funds (DRAFT).

Table 2: Example framework for prioritising M&E within a challenge fund portfolio[49]

Category	Level of analysis
Starting point for all projects After eighteen months, all projects are assessed and moved into category B or A	• Results chain developed linking grant funding and ultimate impact. • Small baseline conducted after project starts but before any changes have occurred. • Indicators developed and monitored with small sample sizes.
Category B: Projects with a low size, strategic importance, potential benefits or innovation	• Indicators monitored to assess attributable changes for enterprise and beneficiaries. (e.g. profits, yields) • Businesses self-report and visited to validate reports. • Beneficiary level data verified by checking with a small number during field visit.
Category A: Projects with a high size, strategic importance, potential benefits, innovation, or potential to change market system	• All "category B" monitoring, plus: • Indicators monitored to assess attributable change in impact indicators (such as income, other benefits for household) • Rigorous studies (mixed methods, larger samples) to validate findings and collect information from direct beneficiaries. • Systemic change assessed by talking with different players, looking at market trends, and linking to project activities. • Further case studies examine aspects of project (e.g. gender)
Closed projects: Projects which closed because they were not financially successful	• If a grantee is not financially successful, monitoring could usefully extract lessons for the challenge fund and other inclusive businesses in the region. This is likely to be based around a case study which analyses the factors contributing to the closure of the project.

4.5 Does current practice meet the standard?

There are several areas of the standard where challenge funds perform reasonably well. For instance:

1. Recent challenge funds have made much more systematic efforts to develop a strategic framework and **articulate a results chain**. This is necessary to assess what to measure and how and who should do it. In the past, the performance of challenge funds in this area has been mixed.[50]

2. The **tracking of programme costs**, in the sense of knowing how much was spent, has been achieved very successfully by challenge funds. This reflects the fact that fund managers have been outsourced to competent professional service organisations.

Challenge funds have been less effective at:

1. Tracking what challenge fund projects have achieved, the **development impact** of the spending has been very much weaker than the financial performance of the business supported. Financial data are easier to collect from the grantees, who may have little interest or understanding of development issues.Where development impacts data is provided by the grantee, notwithstanding the bias which is inherent to the provision of data from supported projects, this is rarely verified with the necessary rigour. As the table below demonstrates, the assessment of impact is often complicated by the selection of vague criteria against which to assess development impact.

2. Basic evaluation principles such as **additionality** (at input, output or behavioural levels) and **attribution** are often not considered adequately in most challenge funds. These principles are important for any rigorous assessment of an aid project, but even more so for a challenge fund. This is because, with a challenge fund modality, is it entirely possible for a supported project to display excellent leverage and development impact, with zero input or output additionality (meaning that the project generates

[49] Kessler, A., op cit.

[50] Enterprise Challenge fund (2009) Mid Term Review

significant private sector development but would have gone ahead without the use of aid funds). The risk of this undesirable outcome clearly increases as challenge funds support projects from a large and wellcapitalised grantee, with only "light touch" input from the fund manager.

3. Whilst many enterprise challenge funds have **scalability or replicability** as core objectives, which should follow through from the demonstration of a successful project – only a very few challenge funds can demonstrate this (Development Policy Centre, 2013). This is important because, conceptually, enterprise challenge funds – whether or not they are explicitly seeking systemic effects – should aim to maintain competitive neutrality and avoid competitive disadvantage for other firms that already are operating, or wish to enter, the same market as a supported project. In other words, "starting races" rather than "picking winners". The risks of failing to ensure competitive neutrality are that any benefits generated and claimed by a supported project may simply have been displaced from another firm that has been excluded from the market. To maximise the chances for challenge fund impacts being replicable and scalable, it is important that the fund manager has access to market assessments to understand market failure risks and the functioning of market systems. This information will allow fund managers to select grantees that have characteristics which are sufficiently similar to a much broader population of enterprises – and so are more likely to be able to scale up from pilot successes with challenge fundfinanced projects.

4. The **reporting of the results** of challenge funds is not characterised by the widespread dissemination of rigorous assessment of fund performance. This is mainly because there is a dearth of robust assessment material. However, even if the material existed, it is important that a neutral entity is engaged to disseminate it – to avoid the current situation where methodologically weak reviews demonstrating the success of challenge funds are distributed either by commercial organisations that are managing funds, or by the donors who are financing them.[51]

   Progress is being made with the technical challenge of introducing rigorous evaluation of future challenge funds. An essential pre-condition for robust evaluation is the publication of the results, whether they are flattering to the donor or service provider, or not. It is important that the development sector rapidly develops a culture of accountability, transparency and selfcritical improvement so that, when evaluations of challenge funds become available, they are disseminated widely and objectively.

In summary, then, the monitoring and evaluation material generated by challenge funds has been extensive – but not entirely helpful. We know a great deal about the operational performance of funds, and this does generate some useful ratios that can be compared between different funds. However, the key contemporary debates tend of focus on the design and development impact of challenge funds and, on these issues, our empirical foundations are shaky. The paucity of reliable evidence to inform the issues which are of most interest to the development community will not endure. Concrete steps have already been taken to progressively fill this gap in our evidence base. Notwithstanding this, it is frustrating that these positive recent initiatives are likely to take several years before we can answer the most fundamental question about the application of challenge funds to development problems – are the development outcomes they generate better than those produced using other aid modalities?

[51] Heinrich, M., op cit.

5.0 Learning the lessons from challenge funds

Challenge funds have an aura of success that is based on shaky foundations. There are numerous examples of successful outputs achieved and impressive leverage ratios – but comprehensive analysis to determine their effectiveness for achieving development impacts to date is almost entirely absent. Hopefully the current emphasis on M&E in new funds will improve this situation.

Seven of the key lessons that have emerged from this review of challenge fund literature and implementation experience are outlined below.

1. Enterprise challenge funds can cause damage as well as good, and funds should adopt a "do no harm" principle. Fund managers should seek to ensure that funded projects do not compromise the competitive neutrality of other businesses in the sector, nor displace either commercial sources of finance or livelihoods from other firms in the sector. This can be achieved by fund managers having an active understanding of the market system context in which they disburse grants.

2. The rationale for challenge funds is to work in partnership with the private sector to generate sustainable development that benefits the target population, but we have very little evidence to assess whether funds are actually delivering these results. Monitoring of challenge funds must be significantly and urgently improved. Development indicators should be carefully monitored and fund managers should not rely on grantees to be the main source of information on the impact of projects on poverty. Programmes should consider the applicability of the DCED standard to challenge funds, and in particular the nuanced application of the standard across a programme's portfolio.

3. DFID should identify a number of priority challenge fund programmes for rigorous evaluation. Independent evaluators should be appointed at the start of fund implementation, and should use rigorous research methods to assess the development impact of the intervention, with a particular focus on demonstrating project attribution, additionality, replication and scale-up, and development impact. The results of independent evaluations should be published, disseminated widely and the results should inform future designs.

4. DFID should fund a thematic evaluation of the challenge fund model – through an ongoing, centrally commissioned cluster evaluation of the priority challenge fund evaluations identified above, which will improve the understanding of the necessary context and conditions for success. This study could also be used to draw cross-comparisons with other modalities.

5. Pursuing a "light touch" approach to fund management may appear attractive in terms of restraining fees to below 20% of challenge fund disbursements – but this may be a false economy. Allowing insufficient funding to conduct robust design and sufficient market system and sector-specific research to understand how projects could have a catalytic effect, without disadvantaging other businesses in the sector, is poor development practice. These difficulties are compounded when challenge funds target very fragile contexts and are dependent entirely upon a demand-side response from appropriate businesses. Adopting an appropriate degree of targeting will support the accumulation of this knowledge and insight, as will combining challenge funds as one component of a larger market-development programme.

6. The development of a broader range of financing options than the standard matching grant product traditionally offered by challenge funds should be considered. Potential grantees do not all face the same development obstacles, and it demonstrates a lack of imagination and local knowledge to offer a single financial instrument as a response. Fund managers should consider equity, loan and hybrid support as well as the scope for results-based aid.

7. Challenge funds do not represent a short-cut to good development practice. Like any other development modality, challenge funds are an instrument which, if used correctly, will generate significant and sustainable development impact. Challenge funds do not obviate the need to define strategic frameworks; plausible results chains and theories of change; appropriate exclusion and selection criteria and monitoring and evaluation frameworks. The selection criteria for each challenge fund (including innovation) are levers to be adjusted by the fund manager, in accordance with the wider strategic framework for the fund.

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Annex 1: How to implement a challenge fund

Selection processes

As per the definition of challenge funds for this guide, selection processes for allocating funding are competitive, whereby a limited pool of funds is available, and eligible applications undergo a comparative evaluation with the best applications receive funding. The precise mechanism for allocating funds can vary with each challenge fund, but typically comprises a two-stage process:

1. The first stage involves submission of a **concept note**, which outlines the project and how it meets the eligibility criteria of the fund. Concept notes are reviewed for eligibility by the fund manager.
2. Eligible concept notes are invited to develop an **application**, setting out the full business case for the proposed project. Applications are appraised by an independent assessment panel comprising recognised technical experts and representatives of the donor organisation.

The rationale behind this two-stage process is to ensure that the transaction costs for the both applicant and the fund manager are minimised by eliminating proposals that are very unlikely to be awarded grants at the concept note stage. A two-stage selection process is thus viewed as a reasonable means for filtering and choosing among proposals.

Costs

Evaluations of completed challenge fund implementations to date illustrate that there is a positive relationship between the number of challenge fund grants and the cost of management resources, and that management cost ratios are lower where aggregated value of funds are higher.[52]

There is limited examination of the distribution of these costs along the duration of the challenge fund. However, a brief analysis of the FDCF aligns with the experience of many fund managers, that challenge fund costs tend to be front loaded, and require heavier inputs during the setup and grantee selection stages than during monitoring, evaluation and dissemination stages.[53]

Financial and administrative arrangements

Set up

A large proportion of the fund managers' inputs are likely to be required during the establishment stage to agree the eligibility criteria and processes for assessing concept notes and applications with programme stakeholders. During this stage, the fund manager will need to decide how the fund will be marketed, and establish the payment mechanisms for disbursing tranches to grantees.

Marketing, support to applicants and grantee selection

Once initial fund processes have been agreed, the fund manager will need to develop a pipeline of strong applications, through implementing targeted marketing, and providing support to applicants in the development of their applications to make them as strong as possible. Significant time will also be spent reviewing concept notes and applications against the fund eligibility criteria and making recommendations on funding decisions to the independent assessment panel. It will also be important to conduct due-diligence on applicants, to minimise fiduciary risk to donor funds.

Monitoring and Evaluation

Once grantees have been selected, the main role of the fund manager is to provide supervision and support to grantees throughout implementation, to ensure that project progress against pre-agreed timeframes and milestones in line with any agreed M&E frameworks. The fund manager will also need to oversee processes for disbursing monies to grantees that have met targets, and preparing portfolio reports to programme stakeholders on project progress and grant expenditure.

Eligibility criteria

While challenge funds vary in their geographic and sectoral scope, they tend to share eligibility criteria that are consistently applied. Generally, all applicants must be able to demonstrate that they have a clean legal and ethical

[52] ECF, op cit., and FDCF (2005), Strategic Project Review.

[53] FDCF (2008), Project Completion Review.

record, and the necessary financial systems in place to minimise fiduciary risk and ensure transparent management of donor monies.

Another common requirement of challenge funds at the project level is that there must be a demonstrable need for funding that cannot be secured through mainstream forms of commercial finance. If projects cannot demonstrate this, then there are questions over the additionality of the challenge fund mechanism, as there is a significant risk that financial support may be provided to a project that would have happened anyway.

When setting eligibility criteria for challenge funds, a delicate balance must be achieved between ensuring funds are open enough so as to encourage submissions from a wide range of private actors, while still being sufficiently well-defined in scope to ensure that grant support is targeting activities that can legitimately claim to be stimulating development.

Payments to grantees

Despite the obvious benefits to donors of disbursing payments to grantees once project outputs have been achieved, in practice it can often be more difficult to implement. In the case of smaller firms that are seeking funding for early stage innovations, they might not have the financial capital available to carry the full cost of project activities. Therefore in order to combat this, it is likely that either the pool of applying organisations is narrowed to larger companies with greater financial capital, or alternatively a more flexible approach to private sector financing may need to be considered.

Monitoring progress of challenge fund projects

Although a number of monitoring and evaluation frameworks have been proposed for challenge fund projects (these are outlined in Chapter 4), there is limited literature outlining standard practical procedures for monitoring the progress of challenge fund portfolios. Therefore the following sections are based on first-hand practitioner experiences.

Grantee reporting

Once grant funds have been allocated, it is important for fund managers to maintain proper oversight of the project portfolio, and in turn request and review reports from grantees. Typically, progress reports are submitted by grantees every quarter and on completion of the project, detailing the current status of project activities against a set of pre-agreed milestones in their contract. In the case of particularly innovative projects, it may also be a contractual requirement for grantees to document lessons learnt from research and development, piloting or trialling a particular model, and for these to be shared with programme stakeholders.

Through this reporting process, fund managers liaise with project managers and request evidence of progress (for example expenditure receipts) before approving disbursements and requesting donors to release tranches where milestones have been met. In the case of remotely managed projects, it may also be necessary for due-diligence visits to project sites to generate a comprehensive understanding of the progress made by the project.

Fund manager reports to programme stakeholders

The fund manager may also be required to provide reports to donors and other programme stakeholders summarising the progress of the challenge fund portfolio. The structure of the report can be adapted to meet individual needs, but typically comprises the cumulative disbursements made to each project.

Engagement with external evaluators

In terms of the arrangements for conducting evaluations, there is a sense in which best practice requires an independent assessment process. Evaluators should be independent of all fund activities to ensure impartiality, and also given the freedom to consult with all stakeholders involved in the challenge fund, particularly:

1. Successful bidders at concept note and application stage (who may or may not have had access to support from the fund manager);
2. Unsuccessful bidders at concept note and application stage;
3. Members of the assessment panel;
4. The fund managers

Evidence from the ECF and BLCF evaluations indicates that evaluators have drawn from a variety of project and grantee reports and held interviews with grantees at project sites. Evaluators have been expected to triangulate responses from programme stakeholders so that accurate impressions of impact are documented.

Timing of independent evaluations

Of the external evaluations that have been conducted for DFID and AusAID challenge funds, no clear guidance has been provided in the reports on the timing of external evaluations . In terms of the timing of reviews for the ECF, BLCF and FDCF, evaluations have been conducted to aid donors in deciding on whether to allocate further tranches of funding. However, almost all of the evaluations have indicated that it is premature for mid or end of term for challenge funds to assess long-term development impacts, and that even short-term development impacts have been difficult to determine except where projects outline a clear Theory of Change.[54]

[54] Enterprise Challenge fund (2009) Mid Term Review and; Financial Deepening Challenge fund (2008) Project Completion Review

Annex 2: Challenge fund catalogue

	Challenge Fund			
	Financial Deepening Challenge Fund	Business Linkages Challenge Fund	Innovations Against Poverty	ProPoor Innovation Challenge
Development Stage	Seed	Seed	Seed	Seed
Approach	Open Call	Open Call	Open Call	Open Call and Selective
Management Arrangements	Independent Fund Manager	Independent Fund Manager	Independent Fund Manager	Donor
Target Beneficiaries	National Corporates, International Corporates	NGOs, SMEs, National Corporates, International Corporates	NGOs, SMEs, National Corporates, International Corporates	Civil Society (MFIs)
Type of Assistance	Grants	Grants	Grants	Grants for Technical Assistance
Size of Fund (£)	10,000,000+	10,000,000+	2,000,000-10,000,000	2,000,000-10,000,000
Number of Grants	16-50	50+	50+	50+
Size of Grants	250,000-1,000,000	250,000-1,000,000	0-50,000, 50,000-250,000	10,000,000+
	Civil Society Challenge Fund	Africa Enterprise Challenge Fund	Enterprise Challenge Fund	Food Retail Industry Challenge Fund
Development Stage	Seed, Start-up, Expansion/Scaling	Seed, Expansion/Scaling	Seed, Expansion/Scaling	Seed, Expansion/Scaling
Approach	Open Call and Selective	Open Call and Selective	Open Call and Selective	Open Call and Selective
Management Arrangements	Independent Fund Manager	Independent Fund Manager	Independent Fund Manager	Independent Fund Manager
Target Beneficiaries	Civil Society	SMEs, National Corporates, International Corporates	SMEs, National Corporates, International Corporates	National Corporates, International Corporates
Type of Assistance	Grants and Technical Assistance	Grants	Grants	grants
Size of Fund (£)	10,000,000+	10,000,000+	2,000,000-10,000,000	2,000,000-10,000,000
Number of Grants	50+	50+	16-50	16-50
Size of Grants	50-250,000, 250,000-1,000,000	50-250,000, 250,000-1,000,000	50-250,000, 250,000-1,000,000	50-250,000, 250,000-1,000,000
	Enterprise Innovation Challenge Fund	Grand Challenges Canada	COOP Africa Challenge Fund	Grand Challenges Explorations Initiative
Development Stage	Seed	Seed, Expansion/Scaling	Start up of business cooperatives	Seed
Approach	Open Call	Open Call	Open Call	Open Call
Management Arrangements	Independent Fund Manager	Independent Fund Manager	Independent Fund Manager	Donor
Target Beneficiaries	SMEs, National Corporates, International Corporates	Civil Society, SMEs, National Corporates, International Corporates, Research Institutions	National Corporates	Civil Society, SMEs, National Corporates, International Corporates, Research Institutions
Type of Assistance	Grants	Grants	Grants	Grants
Size of Fund (£)	10,000,000+	10,000,000+	500,000-2,000,000	10,000,000+
Number of Grants	16-50	50+	50+	6-15
Size of Grants	50-250,000, 250,000-1,000,000	0-50,000, 250,000-1,000,000	0-50,000	50-250,000
	Financial Education Fund	Vietnam Market Participation Challenge Fund	Sawaed Programme	Business Innovation Facility
Development Stage	Seed	Seed	Seed, Start up, Expansion/Scaling	Seed, Start up, Expansion/Scaling
Approach	Selective	Selective	Selective	Selective
Management Arrangements	Independent Fund Manager	Independent Fund Manager	Donor	Independent Fund Manager
Target Beneficiaries	Civil Society, SMEs, National Corporates, International Corporates	Civil Society, SMEs, National Corporates, International Corporates, Research Institutions	SMEs, National Corporates, International Corporates	SMEs, National Corporates, International Corporates
Type of Assistance	Grants	Grants	Grants	Technical Assistance
Size of Fund (£)	2,000,000-10,000,000	500,000-2,000,000	500,000-2,000,000	2,000,000-10,000,000
Number of Grants	6-15	6-15	Not known	50+
Size of Grants	0-50,000, 50-250,000	0-50,000, 50-250,000	0-50,000, 50-250,000	N/A

	Responsible and Accountable Garment Sector Challenge Fund	Development Innovation Ventures	Girls Education Challenge	Grand Challenges for Development Initiative
Development Stage	Seed, Start up, Expansion/Scaling	Seed, Expansion/Scaling	Seed, Expansion/Scaling	Seed, Expansion/Scaling
Approach	Open and Selective	Open Call	Open Call	Open Call
Management Arrangements	Independent Fund Manager	Donor	Independent Fund Manager	Donor
Target Beneficiaries	Civil Society, SMEs, National Corporates, International Corporates	Civil Society, SMEs, National Corporates, International Corporates, Research Institutions	Civil Society, SMEs, National Corporates, International Corporates, Research Institutions	Civil Society, SMEs, National Corporates, International Corporates, Research Institutions
Type of Assistance	Grants	Grants	Grants	Grants
Size of Fund (£)	2,000,000-10,000,000	10,000,000+	10,000,000+	10,000,000+
Number of Grants	6-15	50+	50+	50+
Size of Grants	50-250,000, 250,000-1,000,000	50-250,000, 250,000-1,000,000	250,000-1,000,000, 1,000,000+	50-250,000, 250,000-1,000,000

	Afghanistan Business Innovation Fund	Construction Ideas Fund	Vietnam Business Challenge Fund	Mobile Money for the Unbanked (MMU) Fund
Development Stage	Seed, Expansion/Scaling	Seed, Expansion/Scaling	Seed, Expansion/Scaling	Seed, Expansion/Scaling
Approach	Open and Selective	Open Call	Open Call	Open and Selective
Management Arrangements	Independent Fund Manager	Independent Fund Manager	Independent Fund Manager	Independent Fund Manager
Target Beneficiaries	SMEs, National Corporates, International Corporates	Civil Society, SMEs, National Corporates, International Corporates	SMEs, National Corporates, International Corporates	National Corporates/International Corporates
Type of Assistance	Grants	Grants and Technical Assistance	Grants	Grants
Size of Fund (£)	2,000,000-10,000,000	2,000,000-10,000,000	2,000,000-10,000,000	2,000,000-10,000,000
Number of Grants	6-15	6-15	6-15	16-50
Size of Grants	50-250,000	0-50,000, 50-250,000	50-250,000, 250,000-1,000,000	50-250,000, 250,000-1,000,000

	mFarmer Initiative Challenge Fund	mWomen Innovation Fund	Mobile-Enabled Community Services (MECS) Innovation Fund	
Development Stage	Seed, Expansion/Scaling	Seed, Expansion/Scaling	Seed, Expansion/Scaling	
Approach	Open and Selective	Open and Selective	Open and Selective	
Management Arrangements	Independent Fund Manager	Independent Fund Manager	Independent Fund Manager	
Target Beneficiaries	National Corporates, International Corporates	Civil Society, SMEs,National Corporates, International Corporates	National Corporates, International Corporates	
Type of Assistance	Grants	Grants	Grants	
Size of Fund (£)	500,000-2,000,000	500,000-2,000,000	2,000,000-10,000,000	
Number of Grants	1-5	6-15	16-50	
Size of Grants	50-250,000, 250,000-1,000,000	50-250,000, 250,000-1,000,000	0-50,000, 50-250,000, 250,000-1,000,000	

Annex 3: The DCED Standard for Results Measurement

Elements of the DCED Standard [55]

1. Articulate the results chain. Results chains visually represent how project activities are expected to lead to outputs, outcomes and impact, showing the anticipated causal links and relationships between them. They clearly demonstrate what the project is doing and what changes are expected.
2. Define indicators of change. An indicator specifies what you will measure in order to see whether change has occurred. Indicators are specified for each expected change outlined in results chains.
3. Measure changes in indicators. Once the indicators have been defined, they are regularly monitored to see what has changed and to help projects manage accordingly.
4. Estimate attributable changes. Once a change is observed, you need to estimate what can be attributed to your project. For example, an increase in jobs may be due to your project – or because of the wider economic environment. Estimating attributable changes helps a project identify which interventions are working and which are not.
5. Capture wider changes in the system or market. Many PSD programmes aim to affect entire market systems. Monitoring these changes helps projects identify what is working and revise implementation strategies to maximise results.
6. Track programme costs. In order to assess the success of the project it is necessary to know how much was spent as well as what was achieved.
7. Report results. Findings are communicated clearly to funders, local stakeholders, and to the wider development community where possible.

Manage the system for results measurement. For a monitoring and results-measurement system to be effective, it must be adequately resourced and integrated into all aspects of project management, informing the implementation and guiding the strategy.

[55] DCED (2013a), http://www.enterprise-development.org/page/measuring-and-reporting-results

Annex 4: List of Interviewees

Name	Organisation
Amanda Jupp	Enterprise Challenge Fund
Anne-Marie O'Riordan	Triple Line Consulting
Caroline Ashley	PriceWaterhouse Coopers
David Elliott	DFID
David Smith	Triple Line Consulting
Jeremy Swainson	Coffey International Development
Jonathon Ridley	Coffey International Development
Mark Winters	DFID
Simon Calvert	DFID