

# PRACTICE BRIEF 1

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## What is a challenge fund and when should it be used?

Challenge funds are widely used by governments and donors to finance international development programmes. This Practice Brief defines what they are and how they differ from other financing mechanisms. It lists criteria for choosing when to use a challenge fund and highlights important differences between their use to promote poverty reduction through (a) business enterprise and (b) civil society.

### Key points

A challenge fund is a mechanism for making grants with an explicit public purpose available to organisations, with the most innovative projects selected competitively on the basis of transparent rules. Grantees retain significant control over the formulation and execution of their projects, and share risks with the donor.

Alternative funding mechanisms include managed funds, social impact investment, prize funds, advanced market commitments, social impact bonds and project grants. These differ from challenge funds in one or more significant ways. The selection of the most appropriate funding mechanism depends on how much the specific public purpose is shared between potential collaborators, and their relative ability to contribute towards achieving it.

### What is a challenge fund?

Challenge funds are an increasingly prominent part of the international development landscape, bridging both public and private sectors. The mechanism has been used to reduce poverty by promoting responses from private enterprise, civil society organisations and academia. At best, challenge funds offer a transparent, flexible, creative and cost-effective means of tackling complex challenges. However, evidence relating to their performance and impact has been criticised as being limited (Elliott, 2013; Heinrich, 2013; Kessler, 2013). Evidence to inform decisions about when a challenge fund is likely to work better than an alternative financing mechanisms is also lacking. Therefore, greater clarity is needed about what challenge funds are and how they differ from other mechanisms.

To develop a definition, a review of the existing literature on challenge funds is helpful. Foley (1999) suggests that challenge funds have seven essential features: public competition, scarcity in funding availability, performance related payment, implementation by the bidder, partnership, innovation and private sector participation. The International Labour Organisation (ILO) defines challenge funds as ‘open financing mechanisms that allocate grant funding through a competitive process... to meet specific objectives’ (Co-op Africa, 2010:2). The Swedish International Development Cooperation Agency (SIDA) (2013) emphasises their role in allocating donor money for specific purposes in a predefined field. For Heinrich (2013:6), challenge funds ‘competitively award grants to business models or projects that are able to address a particular, defined development problem’. Armstrong et al. (2011:5) define challenge funds as ‘cost-sharing grant schemes which are designed to challenge the private sector to propose innovative new business models that engage and benefit the poor, on a replicable and sustainable basis’. A bias is noted in these definitions towards enterprise-centric challenge funds, even though the same mechanism can be used to support civil society. Drawing on these definitions, recognising the core idea of a ‘challenge’ but elaborating on this by considering the seven institutional characteristics of any financing mechanism, Triple Line and the University of Bath present a more inclusive definition of challenge funds:

A challenge fund

- (1) Provides grants or subsidies
- (2) With an explicit public purpose
- (3) Shared between independent agencies, with grant recipients
- (4) Who are selected competitively
- (5) On the basis of advertised rules and processes
- (6) Who retain significant discretion over formulation of their proposals and execution of their project and
- (7) Who share risks with the grant provider.

**Table 1:** Distinguishing challenge funds from a sample of other funding mechanisms

Summary of features of other funding mechanisms in comparison to challenge funds	
Managed funds	A more generic term for a portfolio of investments that may or may not have a grant/subsidy element and an explicit public purpose. Similar to challenge funds in that the grantee retains autonomy in funded project implementation and shares project risks with the donor, but selection tends to be more actively managed by the donor. The selection process may consequently also be less transparent (see Brown <i>et al.</i> , 2013:13).
Social impact investment	Similar to managed funds in that the fund manager plays a more active role in grantee selection, which is generally not openly competitive and transparent. The fund provider generally seeks both a commercial return and success in meeting a wider social or public purpose.
Prize fund	Generally based on a competitive and transparent selection process but often to meet corporate public relations goals as well as wider public aims. The grantee has a high degree of autonomy over how to spend the funds, reflecting a weaker specification of expected outcomes and impact.

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<sup>1</sup> For an overview of challenge funds in international development see O’Riordan *et al.* (2013), available online at <http://www.tripleline.com/wp-content/uploads/2014/03/Challenge-Funds-in-International-Development1.pdf>

## Types of challenge funds

Challenge funds can be categorised in many ways, including on the basis of their public purpose, geographical scope and target grantees. An important distinction can also be made according to the criteria by which the performance of grantees are assessed. All challenge funds expect grantees to contribute towards the achievement of a specified public purpose, but how robustly this is assessed varies greatly. For example, social and civil society orientated challenge funds aim to support poverty alleviation, rights and increased access to improved social sector services (e.g. health, education, water and sanitation) for marginalised groups. On the other hand, enterprise challenge funds (ECFs) focus more on a contribution to economic growth and employment creation. ECFs are distinct in additionally requiring that project ideas pass the ‘business test’ of contributing to the commercial viability and economic sustainability of the project.<sup>1</sup> The definition of challenge funds provided in this Practice Brief is sufficiently broad to include those that do require this, and those that do not.

## Other funding mechanisms

To test the robustness of this Practice Brief’s challenge fund definition, we establish a clear distinction between challenge funds and other funding mechanisms. Table 1 lists a sample of these mechanisms and summarises how they compare and contrast with challenge funds on the basis of the presence of a grant or subsidy element, an explicit public purpose, an inter-agency contract, a competitive and open selection process, grantee autonomy in project implementation and donor–grantee risk sharing. This demonstrates that the challenge fund model is a distinct funding mechanism.

### Summary of features of other funding mechanisms in comparison to challenge funds

Advanced market commitment	Grantees are challenged to meet a tightly specified goal, with the donor seeking to encourage risky investments with beneficial public outcomes by reducing uncertainty about associated financial returns.
Social investment bond	Donor offers a financial return to grantees if they fulfil precise contractual terms for delivery of services with public benefits. Intended to transfer risk from the public funder to the private sector, as well as offer the latter incentives to innovate. Grantee selection may be openly competitive and transparent but need not be so.
Project grants	Donor seeks to retain greater control over detailed design of activities as well as their goals. May or may not be offered through an openly competitive selection process.

## When to use the challenge fund mechanism

Equipped with a definition for challenge funds, acknowledging the different types of challenge funds which can exist, and understanding that the challenge fund mechanism is a distinct funding model, it is now time to discuss the circumstances under which challenge funds should be the financing mechanism of choice in achieving complex international development goals. Table 2 provides a starting point for considering the suitability of challenge funds by offering a general rationale for their seven design features.

Following years of experience in designing, managing and evaluating challenge funds, we have identified the following reasons for setting up a challenge fund:

- (1) To stimulate innovative responses to complex problems for which there is (as yet) no standard solution, such as how to reach marginalised people
- (2) To stimulate responses to a problem that need to be tailored to diverse contextual factors, by tapping into local knowledge and creative capacity to develop context-specific responses
- (3) To identify a range of potentially complementary responses to a problem, which are capable of having

systemic impact – e.g. within a specific value chain or industrial cluster

- (4) To engage with smaller, less well-known organisations and channel additional resources to organisations with underutilised capacity to initiate, implement and evaluate activities in a specified field
- (5) To demonstrate to grantees the advantages in joining a mechanism in which they control project design and implementation, and which supports capacity building and learning to promote best practices
- (6) To strengthen performance management, institutional learning and accountability by devolving influence over resources to multiple grantees
- (7) To disburse large amounts of funding quickly, by contracting in additional expertise, particularly for donors facing tight staffing constraints
- (8) To build flexibility into funding portfolios in a way that can accommodate uncertainty and variability in funding availability
- (9) To reconcile flexibility with achieving economies of scale in management of related activities
- (10) To distance donors from politically sensitive activities, by delegating resources and responsibility to grantees who hold greater local legitimacy.

**Table 2:** Points for consideration in the selection of the challenge fund mechanism

Feature	Prevailing conditions/circumstances
Nature of the transfer	A designated budget to provide grants or subsidies (often as a means of leverage) with low associated transaction costs.
Public goal	Available for a specific goal that will be achieved by allocating funds to the most innovative project ideas and business models.
Relationship	Limiting availability of funds to organisations external to the donor.
Eligibility for funds	Potential external demand from grantees exceeds budget available and there are grounds for believing competition will elicit more and better applications for funding.
Screening and selection	Transparent rules likely to attract more interest, be seen to be fair and reduce risk of discriminatory allocation influenced by vested interests.
Division of labour	Advantages of recruiting relatively autonomous grantees into design and implementation of project activities, relative to expanding in-house capacity.
Risk management	Donors responding to grantees' needs in the provision of funding that may not otherwise be available to the latter, as well as sharing in the risk of the project.

The first five of these points make a clear public interest case for challenge funds in that they highlight nuanced situations where the mechanism may have advantages over others. The last five focus on the attractions of the challenge fund model for the donor, but with the possibility of some conflicts of interest, particularly in the case of the last argument regarding the need for donors to gain political distance. From the point of view of grantees, the case for challenge funds also depends upon the precise terms under which funds are available, particularly the extent to which such funding is associated with loss of autonomy, and the costs of compliance with monitoring and accountability requirements.

## Concluding remarks

This Practice Brief has offered a robust definition of challenge funds covering their use in international development both to promote business enterprise and civil society activities. It has explored how they differ from other development funding mechanisms and outlined when they should be considered to tackle development challenges. Much scope remains for empirical research into the way challenge funds are designed, implemented, managed and appraised.

## References

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This Practice Brief was written by Anne-Marie O'Riordan, James Copestake, Juliette Seibold and David Smith. Readers are encouraged to quote and replicate material from these Practice Briefs in their own publications. In return Triple Line requests due acknowledgement and quotes to be referenced.

This is the first Practice Brief in a series of papers that examines challenge funds as an aid modality.

**Practice Brief One:** What is a challenge fund and when should it be used?

**Practice Brief Two:** Designing a challenge fund: Important considerations

**Practice Brief Three:** Considerations for challenge fund management (*forthcoming*)

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