

Many people living in poverty lack access to productive employment and the resources that would support them in making a living. The private sector can contribute with innovation, employment, and economic growth that can improve living conditions for people in low- and middle-income countries. However, due to uncertainty and risks present in developing markets, it is often difficult for entrepreneurs to obtain loans and attract investors.

### WHAT IS A CHALLENGE FUND?

A challenge fund is a grant based instrument that stimulates innovation and mobilizes resources, and one of Sida's financing mechanisms through which to support private sector development. Through challenge funds, both profit and non-profit organizations compete for funding to develop and scale innovative solutions to a pre-defined development challenge, such as increasing agricultural productivity, energy efficiency, renewable energy, climate adaptation or strengthening democracy. This is a way to reach and stimulate markets that are considered too risky by formal financial actors. The ambition is to unlock hidden innovative and locally rooted solutions to development problems.

Challenge funds thus create opportunities to support entrepreneurs and small- and medium-sized enterprises that want to develop innovative products and services that contribute to sustainable development and poverty reduction which financial institutions often consider too risky to invest in with too low/uncertain returns. Promising social innovations often fall between the cracks and do not qualify for either grant assistance or commercial capital. The goal is that these companies can scale up their activities and business, and access commercial capital after the support from a challenge fund has ended.

Challenge funds are often referred to as an instrument for development cooperation to mobilize resources and capital from the private sector, and for aid to act as a catalyst to promote innovations that contribute to development goals. However, challenge funds can also be used to stimulate and support critical innovation within for example civil society, research and academia, and the public sector. Support

could then be obtained, for example, for investments in local knowledge to improve governance, transparency, rights, and access to services, or to strengthen citizens' voices and influence.

### STRUCTURE OF A CHALLENGE FUND AND TYPE OF SUPPORT OFFERED

When seeking grants from a challenge fund, innovators compete with each other to propose the best solution to a specific development problem. This is done through the fund issuing a call for proposals, in which it details the type of development problem that needs to be solved. The applicants whose ideas best meet the predetermined criteria receive a grant to implement their ideas.

In addition to receiving financial support, innovators are also required to co-finance the project. The size of this co-financing requirement varies across challenge funds, and depends on the design of the fund, local market conditions, and the type of actor it seeks to target.

In addition to financial support, many challenge funds provide technical assistance and investment readiness support. This is provided not only to strengthen the innovators' capacity to develop their innovations and attract private capital, but also to ensure sustainable development impact.

Some challenge funds also focus on the enabling environment surrounding these innovations, by for example seeking to address specific policy-related barriers that prevent innovative solutions from scaling and reaching their full potential.