Briefing Paper: No.1
Challenge Fund: An Innovative Financing Mechanism for Forest Sector Transformation

Introduction

Ethiopia's forests provide valuable economic, ecological, social, and cultural benefits and contribute to the country's growth.

Key Messages

- Ethiopia's forests provide valuable ecological and economic resources yet are under threat.
- Existing financing institutions, both government and private, focus mainly on short maturing loans giving less priority to forestry.
- The Government decision makers and donors should design mechanisms to effectively access existing sources of multilateral, bilateral & explore in-country funding for REDD+ including from public and private sources.
- The need for financing by developing countries is greater than the funding currently available.
- Various challenge funds have been established to support climate financing in developing countries since 1999.
- Challenge Fund is a new aid instrument and modality to attract private sector into Forestry.
- Challenge Fund is a competitive non-reim-bursable funding/grant with 50% Cost-sharing modality.
- Successful implementation of Challenge funds requires neutral 3rd party management &

Despite the dependence of many rural households on forests for their livelihoods[1], forests' contribution to agriculture, tourism, construction, income generation from non-wood forest products and the provision of ecosystem services, enhancement of the water cycle and protection of biodiversity, the value of the forest sector is not well recognized[2] and is not accurately shown in the System of National Accounts.

Ethiopia's remaining forest resources are under threat from subsistence and large-scale agricultural expansion, unsustainable fuel wood collection, limitations in enforcing legal and regulatory frameworks, weak program/project implementation capacity, institutional instability, inadequate financial incentives for community and private sector investment.

Reversing the above-mentioned trend and achieve zero net emissions could be possible through the establishment of funding facilities that would encourage the private sector to engage in forest development, add value to forest products and contribute to import substitution of wood. This, in turn, could pave the way to access multilateral and bilateral funding sources to further develop and strengthen the forest sector.

While international financing is very essential, it is equally important to explore domestic funding opportunities for REDD+ oriented actions including from public and private sources as stated in Ethiopia REDD+ Strategy issued in 2018.

Given the long gestation period of forest crops, access to long-term financing is crucial for investment to develop forests and associated value chains. However, existing finance institutions, both government and private, focus mainly on loans that mature in the short-term. For example, state-

[1] National REDD+ Strategy (2016 - 2030).

[2] Although studies (UNEP 2026) show that the forest sector contributes 12.8% to GDP, this is not shown in the System of National Accounts. Often, the forestry's contribution is aggregated in agriculture and is underrepresented.

The Federal Democratic Republic of Ethiopia
Ethiopian Forestry Development
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owned banks give priority to the manufacturing sector based on the priorities set by the government. The Development Bank of Ethiopia for instance only invests in forestry when the project has a major industrial component. This results in scarcity of long-term, low-yielding capital available for commercial forestry, particularly forest plantation development. This discourages the private sector and community-based entrepreneurs to engage in afforestation, restoration, eco-tourism, and conservation activities. In this regard, creating access to finance by establishing financing mechanisms could boost possibilities for achieving Ethiopia's ambitious targets to a) increase forest cover to 20% by 2020; b) increase forestry's contribution to GDP to 8% by 2020; and c) achieve 130 MMt CO2e reduction by 2030; representing approximately 50% of the overall CRGE and NDC carbon sequestration and emissions reductions goals. The challenge fund (CF), an innovative and alternative financing mechanism, has huge potential to encourage and attract the private sector to actively engage in forest development and management.

The Government of Ethiopia and its development partners need to act to stimulate and catalyze interest and create incentives for increasing investment in the forestry sector, which otherwise would not happen because of perceived and/or real risks associated with ease of doing business, financial returns, market opportunities and policy and legislative (enabling operational environment) considerations that encourage or dissuade investors.

What is a Challenge Fund?

A challenge fund is a financing mechanism, which earmarks funds (made available from public sources, through the contributions of development partners or private donors) to meet specific objectives including, among others, a) extend financial services to resource-poor people with entrepreneurial drive and initiatives b) find solutions to a specific social problem; c) trigger and support investment; and d) pilot and adopt innovative best practices, creative solutions, etc. When challenge funds are created and operational, community-based organizations, private enterprises, etc. could apply for funding following established guidelines and procedures and will be assessed based on the quality of their proposal/business plan and relevance to the desired outcome.

History of Global Challenge Fund Practices

Challenge funds have been applied by donors since the late 1990s and there are a variety of such funds. The DFID was a pioneer in setting up challenge funds for development purposes in 1999. The first efforts included four CFs for business linkages, financial deepening, tourism, and civil society. The Consultative Group to Assist the Poorest (CGAP) launched a competitive innovation fund in 2002, a Pro-poor Innovation Challenge, to provide grants to microfinance organizations for adopting innovative methodologies to deepen rural poverty outreach and impact. Australian Aid (AusAid) and Canadian Aid followed, and USAID supports large scale challenge funds. Some of the challenge funds are very large to the tune of **US$ 225 million**, for example **Grand Challenge Canada**, a CF focusing on innovations in health. Other examples of global challenge fund include those undertaken by the UN, the Bill & Melinda Gates Foundation and a less well-known organization the Mohammed Bin Rashid Al Maktoum Foundation. Some CFs that are operational in Africa include **Africa Enterprise Challenge Fund** (AECF), Malawi Innovation Challenge Fund (MICF), AgriFI Kenya Challenge Fund, UNDP Ethiopia, Sustainable Rural Energy Technologies (RETs) Innovation Award.

The rationale behind Challenge Funds

Donor community and governments are driven by several factors in implementing challenge fund mechanism in various sectors, for example since 1990 to date:

- development assistance tries to engage more actors than in the past, the business community.
- Competition for funding is increasingly seen as a method of achieving development outcomes through identifying, piloting, or scaling-up smart and cost-effective solutions.
- Innovation is moving up the development agenda as a means of solving major societal problems, including poverty and environmental issues. Innovation strategy lends itself to the challenge fund concept.
- Challenge funds are believed to provide leverage of donor funds by engaging private capital in matching the financing of projects.
- Challenge funds are considered to allow for directly working with commercial players without creating market distortions.
- Challenge funds are different from conventional competitive bidding processes as CFs seek to provide generic results rather than specific; they focus on a desired outcome or result but are not prescribing the means of how such results should be achieved, and they allow several winners.

Management of Challenge Funds

Figure 1: Possible Impacts of CF

The management of challenge funds is usually subcontracted to specialist organizations through a competitive bidding process. These include **Coffey Intl**, **Nathan Associates**, **DIV, Landell Mills, KPMG, PwC** and in the Ethiopian context, the Development Bank of Ethiopia (DBE). The impacts of introducing CF were that some achieved high social impact combined with high financial returns whilst the majority achieved a combination of reasonable social and financial returns. The leverage effect for job creation was 1:2 with private sector investment for some Business Linkage Challenge Fund financed by DFID[3] (see Figure 1). Similar results could be achieved in Ethiopia if appropriate actions (setting-up mechanisms, allocating fund, etc) are taken based on existing experience and following relevant legal provisions.

The Process for Implementing Challenge Fund

1. A challenge fund invites for proposals from companies, organizations, entrepreneurs, and institutions working in a targeted field to submit project proposals.

[3] SIDA Challenge Funds Guideline: A guide based on Sida's and other actors work using Challenge Funds in development assistance/as a method for development.

2. Applicants submit brief concept notes followed by full proposals which are assessed against transparent and pre-determined criteria.
3. Successful applicants must usually match a certain percentage of the non-reimbursable fund/grant with their own finance up to (50%). Cost-sharing is applied as it creates commitment by the applicant (private company or public institution) and provides leverage for donor funding. Cost sharing could be in the form of cash, labor, materials, land, etc. The CF awards grants to those projects that best meet the objectives of the fund and fulfill various eligibility criteria outlined below. The generic process to implement challenge Fund is shown in Figure 2:

Figure 2: Process for Implementing Challenge Fund

Challenge funds provide the private sector opportunity to develop innovative products, services and business models that can pave the way for solving social, economic, or environmental problems, while successfully maximizing their competitiveness and profitability.

Generic Challenge Fund Criteria

The feasibility of a challenge fund could be assessed based on the following criteria[4]:

- **Viability:** This includes market, commercial, financial, and technical.
- **Social impact:** The scale, type, and risk of social impact for low-income beneficiaries and the approach towards the inclusion and economic empowerment of women and young individuals.
- **Innovativeness:** Inclusive business models must have innovation as a key factor to deliver the expected commercial, social, and environmental impact. Innovation can be product innovation (features, functionalities and performances of products/service offerings); process innovation **(**the way the pro-ducts are made or delivered, e.g. manu-facturing, distribution, and support of products and services);
- **Potential for Sustainability and Scale-up:** The inclusive business initiatives must prove that they will become sustainable and have potential for scaling up and benefit the wider community.
- **Business approach:** Responsible business practices with respect to labor administration, environmental safeguards, payment of tax, ethical and anti-corruption practices, and respecting other relevant legal frameworks.
- **Leverage (additionality): Possibility of the CF for complementing** other existing commercial funding alternatives.
- **Cost effectiveness: Possibility for** co-investments of more than 51%.
- **Risk**: Political, security, possibilities, or limitations for partnerships.

[4] www.innovationsagainstpoverty.org

Risks associated with Challenge Fund Implementation

- Failure to deliver developmental impacts or innovative approaches can turn the fund into a subsidy scheme that benefits only a few enterprises and damages the reputation of the sponsor organizations.
- Interference or inaction by decision makers can negatively influence the selection of projects and the overall results.
- Limited participation or interest from the private sector.
- Poor quality of proposals.
- Legal risks related to contractual non-compliance by awarded companies, and fraud.

Conclusions and recommendations

Challenge Funds have a promising potential to leverage additional financing from private sector and interested donor community and have a capacity to address the needs of poor people if they are backed by legal supports from decision makers. Accordingly, the following actions are recommended to various actors:

a) To Government Policy and decision-makers

- The government of Ethiopia, including regional governments should set up regulatory mechanisms for access to finance.
- Prepare attractive financial incentives such as low interest finance or interest free finance or even grant for the private sector to opt forestry as viable business/venture.
- Establish Trust Fund for private companies, communities, and individuals so that they can draw on conditional basis to restore.
- Promote/publicize challenge funds widely.
- Conduct continued dialogue with the private to raise confidence and investing in forestry as business.
- Follow-up, provide support and monitoring projects to ensure they deliver the desired results.

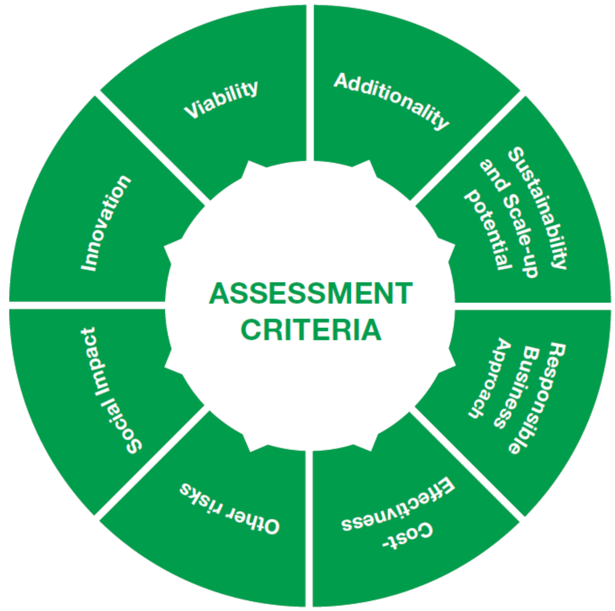

Figure 3: Feasibility Assessment Criteria for CF

b) To Development Partners

- Devise less stringent requirement for private sector and public sector who are willing and/or operating in forest plantation, restoration of degraded areas and already engaged in forest industry.
- Support the financial sector with co-financing, knowledge, systems, alternative financing mechanisms for forest sector.
- Conduct awareness raising and provide information on available financing mechanisms.
- Be willing to establish alliance with private sector to share financial and other resources.

c) To the Private Sector

- Be prepared to look beyond short-term gains and play a role in shaping fate of the future through responsible business enterprises.
- Begin to see forestry as commercially profitable venture.
- Be willing to take calculated risks for transforming the environment and forest sector.

- Be willing to come up with matching fund.

d) To Financial Institutions

- Revise their policies to make finance accessible to investors committed to the sector.

e) To Academic and Research Institutions:

- Support and/or conduct research on new financing mechanisms.
- Share information on successful financing models and help in evaluations.
- Provide research outputs on profitable forestry business options, low-cost land restoration to attract the private sector.
- Prepare short-term trainings for students and the private sector on alternative financing mechanisms.
- Work on establishing academic graduates fund for forestry business and develop curriculum on financing mechanism contextualizing for the country.