

# Enhancing Nepal's Investment Competitiveness: An Institutional and Regulatory Analysis<sup>1</sup>

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## Executive Summary

**Nepal needs much stronger growth if it is to attain the government's objective of achieving middle-income status by 2030.** Over the past decade, Nepal has achieved an average growth rate of a little over 4 percent. This was largely driven by strong remittance flows that contributed more than one-quarter of gross domestic product (GDP). However, this remittance-driven model cannot deliver the high levels of growth needed to achieve the government's ambitious development targets. Stronger trade and investment performance and greater integration in the global economy are also needed.

**Nepal's foreign direct investment (FDI) inflows are low and volatile, and show high levels of concentration in terms of source and sectors.** FDI inflows have plateaued at less than 0.5 percent of GDP. FDI inflows as a share of GDP are substantially lower in Nepal than other countries in South Asia, such as Bangladesh, India and Sri Lanka, as well as countries in Southeast Asia, such as Lao PDR and Cambodia. Nepal also depends on a more limited range of source countries for its FDI. Nepal's FDI has also become concentrated in fewer sectors in recent years, with the majority of investment targeting the supply of the domestic market (market-seeking investment).

**Improving the institutional performance and the overall investment climate are key in attracting FDI and strengthening Nepal's competitiveness.** This is supported by the findings of the World Economic Forum's (WEF) Global Competitiveness Index (2017-18), in which Nepal ranks 88 for 2017-18, an improvement of 10 spots compared with 2016-17. In terms of regional ranking, Nepal was fourth after India (40), Bhutan (82) and Sri Lanka (85). Technological readiness, efficiency in the labor market, and higher education and training remain areas of concern. A weak enabling environment discourages entrepreneurship and investor confidence in the overall business climate. Nepal ranks 110 in the World Bank's Doing Business 2019 report. There is substantial scope for improvement along several dimensions, including paying taxes, contract enforcement, dealing with construction permits, and the ease of getting electricity and starting a business.

**This policy note aims to provide an overview of Nepal's current and potential position in attracting foreign investment. The note suggests short- and medium-term reform actions.** It begins by assessing recent trends in FDI and proceeds to evaluate the institutional framework for investment policy and promotion, and the legal and regulatory framework that governs FDI in Nepal, based on which policy recommendations are made.

**The institutional framework for foreign investment in Nepal is complex, with multiple institutions involved in investment policymaking and their implementation.** These include the Department of Industry (DoI), Investment Board of Nepal (IBN), the central bank Nepal Rastra Bank (NRB), and the Industrial and Investment Promotion Board (IIPB). Some of the responsible agencies have overlapping mandates. Furthermore, with federalism under the new Constitution, it is not clear how the licensing, permits and inspection processes will be affected by the multiple layers of government.

**Foreign investment in Nepal is also governed by a number of laws and regulations that overlap in certain respects.** These include: (i) the Foreign Investment and Technology Transfer Act 1992 (2048) (FITTA); (ii) the Foreign Exchange (Regulation) Act 1962 (2019); (iii) the Investment Board Act 2011 (2068); and (iv) the Foreign Investment and One Window Policy of 2015, the Non-Resident Nepali Act (2008) and Non-Resident Nepali Rules (2010). There are several new acts in the pipeline, such as the Foreign Investment Act and the PPP-IBN Act, which will impact the regulatory framework on FDI once they are implemented.

**Currently, prior approval is required by foreign investors before investing in Nepal.** Nepal has an ex-ante screening process that requires foreign investors to obtain prior approval before investing. The approval process for foreign investment in Nepal is often discretionary and delayed. The legal framework for FDI in Nepal imposes a minimum investment requirement, which is not considered good practice. The current legal framework also imposes a foreign equity cap in many sectors. Entry of foreign investment into Nepal is subject to both a negative and a positive list.

**The current framework for foreign investment in Nepal, the Foreign Investment and Technology Transfer Act (FITTA), does not provide the core protection guarantees of non-discrimination.** Contrary to good international practice, FITTA does not contain the core principles of national treatment and most-favored-nation (MFN) status. This lack of protection under domestic law may also result in a breach of Nepal's bilateral investment agreements and free-trade commitments, where such non-discrimination guarantees are agreed upon.

**The scope of protection against expropriation is narrow.** While there are different legal instruments that protect investors against direct expropriation, the scope of protection against expropriation is narrow (i.e., nationalization) and does not extend to indirect expropriation, which can have a similar impact as direct expropriation. Also, the protection against expropriation does not provide the guarantee of due process.

**The scope of investors' repatriation rights in Nepal falls short of international standards.** Repatriation rights do not explicitly guarantee repatriation of payments obtained as compensation from expropriation, or any indemnity or compensation received as a result of final resolution of a dispute. The law does not require prior approval for the repatriation of foreign investment. However, in practice, it is subject to dual approvals by NRB and the DoI, with no prescribed time period within which these approvals can be obtained. FDI divestment and repatriation are further restricted by a one-year lock-in period. There are also restrictions on the repatriation of service fees and the income earned by foreign nationals.

**The existing legal framework does not provide a dispute settlement mechanism between foreign investors and the State.** The measures for the settlement of disputes prescribed in FITTA are concerned only with disputes between the foreign investor, the national investor and the industry. As Nepal is party to several international investment agreements (IIAs), it is important for the Government of Nepal (GoN) to ascertain the gap that exists between Nepal's commitments in its IIAs and its domestic legal framework on investment; and to determine to what extent the de jure IIA commitments are actually implemented in practice.

**There are several constraints related to transactions for foreign investment in the existing regulatory framework.** Foreign lenders are subordinated to local banks in priority of repayment and this creates a disincentive to foreign lenders. The current interest rate cap on foreign currency loans (12-month US\$ LIBOR + 550 bps, including the hedging cost) is unattractive to foreign lenders. The creation of a mortgage of land in favor of foreign lenders requires cabinet approval and the enforcement of security requires a court order, making the process lengthy.

**This policy note makes several recommendations for reforms in the current regulatory and institutional framework governing FDI.** The reform recommendations summarized below include: (i) having a coherent strategy for attracting and retaining investment; (ii) rationalization of the institutional structure governing FDI; (iii) implementing a modern investment law that adheres to international best practice on approval

of FDI, investor protection, repatriation, dispute resolution, etc.; and (iv) the easing of transaction-specific constraints to foreign investment.

**There is need to articulate a clear investment policy statement through a comprehensive process of stakeholder consultation.** The investment strategy could target foreigners, non-resident Nepalis, as well as domestic investors and address how constraints to investment will be dealt with.

**It is recommended that the mandate and resources for investment promotion be given to a single agency.** This agency should then develop an action plan for investment promotion, implement the overall investment strategy of the GoN, and provide investment aftercare services.

**The FITTA needs to be replaced with a modern investment law aligned to international commitments and internationally recognized best practice.** This revised law should eliminate ex-ante screening and approval mechanisms and discriminatory treatment to FDI, reduce red tape and bureaucracy affecting entry/establishment of investment in the country, streamline the business establishment processes, and implement the “one-window system” policies as enshrined in the “Foreign investment and one-window policy” of 2015. The new investment law should allow for automatic approval of FDI in general and abolish the “minimum investment requirements” to encourage the free flow of investment into the country.

**The legal framework requires a full set of investor rights and investor protection, and the repatriation process needs to be reformed.** A standard range of investor rights, including asset protection and enforcement rights consistent with the country’s IIAs need to be incorporated. The time involved in repatriation, as well as the number of procedures in the repatriation process, should be reduced. Additional approval requirements in the repatriation processes can be eliminated. Discretionary practices for repatriation of proceeds/fees from technology transfer arrangements, as well as the DoI approval requirements for repatriation of fees concerning management agreements, need to be reformed.

**An updated foreign investment act should adhere to internationally recognized best practice on a dispute resolution framework.** It should provide for a dispute settlement mechanism between foreign investors and the State, and include a dispute resolution mechanism through arbitration, preferably international arbitration. The involvement of the DoI in the mediation process for disputes involving foreign investments should be eliminated. There should be an effective grievance management mechanism to resolve issues faced by investors early on to prevent them from escalating into fully-fledged disputes.

**Transaction-specific constraints to foreign investment need to be eased.** Foreign lenders should be granted *pari-passu* treatment with local lenders in terms of the priority of repayment. Currently, they are subordinated to local banks. The rationale behind an interest rate cap on foreign currency loans should be revised and hedging cost should be separated from the total interest rate cap. The procedure for the creation of mortgages of land in favor of foreign lenders needs to be made easier.

**The government has some ongoing initiatives that seek to address the shortcomings of the current regulatory framework and improve the conditions for FDI in Nepal.** There is a Foreign Investment and Technology Act draft bill under discussion within the government. NRB proposes to issue directives to enhance foreign lenders’ rights by facilitating the perfection and enforcement of collateral through local agent banks and increase financing sources through higher limits on foreign currency borrowings. These reforms, once implemented, are expected to improve the climate for FDI in Nepal.

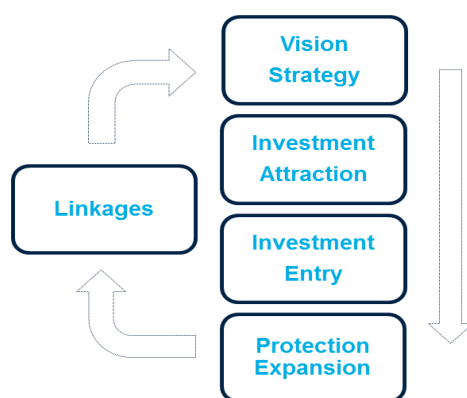
## I. Introduction

**Nepal has been one of the slowest growing economies of South Asia, with growth averaging just over 4 percent a year. The present remittance-driven model is unable to deliver sustainable growth in GDP or employment.** The lack of adequate jobs has led to more than one-quarter of the labor force working overseas. Their remittances, more than one-quarter of GDP, are believed to have underpinned a dramatic 28-percentage-point reduction in poverty between 2003 and 2011. However, this has also led to an appreciation of the real exchange rate, which has hurt exports and resulted in rising imports. Without a significant rebalancing of the economy toward a more investment-led model, growth is unlikely to exceed 5 percent. The current growth rate is insufficient for the country to meet the government’s objective of achieving lower middle-income status by 2030.

**Trade and investment can be important drivers of growth, but performance has been lackluster.** Nepal’s exports and imports are lower, on average, than other countries at similar income levels, even after accounting for its size, remoteness from main markets, and its landlocked status. The situation has worsened relative to the 1990s. The trade-to-GDP ratio has declined from an average of 59 percent between 1995 and 1999, to 46 percent between 2010 and 2014. Merchandise export growth has almost flat-lined. Exports are concentrated in a narrow range of agricultural and low value-added manufactured products, in globally declining market segments. Moreover, Nepal exports only to a handful of countries. Services exports have performed better, growing on average by 17 percent annually since 2005 and reaching US\$1.2 billion (54 percent of Nepal’s total exports) in 2014. However, exports of services are also concentrated in just a few industries.

**Achieving greater integration in the global economy and building a competitive export sector will require addressing several economic and institutional challenges.** To aid this process, the Government of Nepal (GoN) has devoted substantial resources to promoting trade, foreign direct investment (FDI), and tourism. As part of the Nepal Trade Integration Strategy 2016 (NTIS 2016), the GoN has attempted to strengthen the enabling environment for business to attract potential domestic and foreign investors.

Figure 1: The investment lifecycle



Source: Investment & Competition unit, MTI Global Practice.

**This note evaluates the legal, regulatory and institutional framework for FDI.** It assesses the role of FDI in Nepal’s economy, and evaluates the legal, regulatory and institutional framework for investment policy and promotion. It explores opportunities and constraints for investment through the application of the

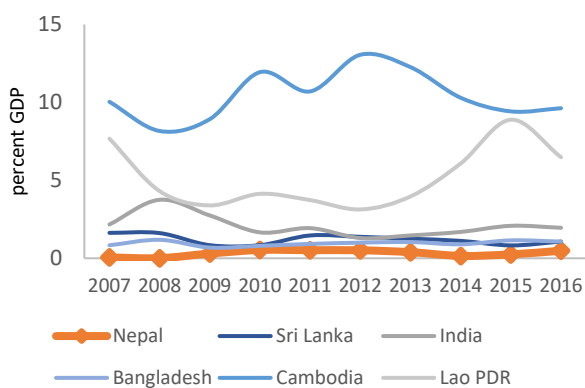
Investment Lifecycle Model (Figure 1), which depicts the dynamic relationship between FDI and the host country, and the various steps throughout that relationship. In addition to the legal and institutional framework for FDI, there are several other factors that determine the competitiveness of a country in attracting FDI. These include adequate infrastructure, human capital, access to land, and enabling business climate conditions to operate a business (ex-contract enforcement, a good tax administration system, etc.). These additional factors that determine the overall competitiveness of the private sector of Nepal are discussed in much greater detail in the Nepal Country Private Sector Diagnostic (CPSD), World Bank (2018).<sup>2</sup> This note focuses on the regulatory and institutional aspects related to FDI.

**The note is organized as follows.** Section II presents a snapshot of Nepal’s FDI trends across time. Section III provides an assessment of Nepal’s legal, regulatory and institutional environment for investment, and Section IV presents recommendations for reforms.

## II. Understanding Nepal’s FDI Experience – The Nepal FDI Snapshot

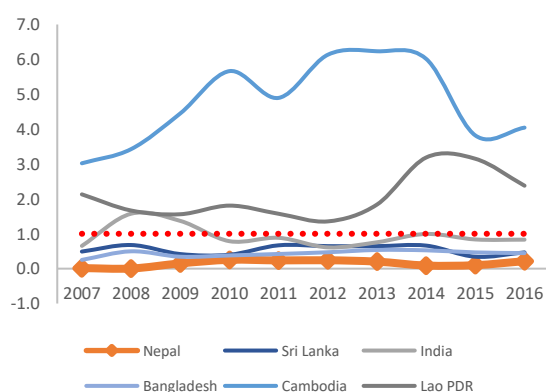
**Over the past decade, FDI inflows into Nepal have been volatile and low relative to regional and global comparators.**<sup>3</sup> Nepal’s FDI inflows have marginally recovered since the collapse in 2008, and have plateaued at less than 0.5 percent of GDP (**Error! Reference source not found.Error! Reference source not found.**)<sup>4</sup> FDI inflows as a share of GDP in Nepal are substantially lower than other countries in South Asia, such as Bangladesh, India and Sri Lanka, as well as countries in Southeast Asia, such as Lao PDR and Cambodia. Even after normalizing for economic size by dividing a country’s share of Global FDI by its share of Global GDP to arrive at a measure of a “fair share of global FDI” (the FDI performance index), Nepal performs poorly compared with peers (Figure 3).

**Figure 2: Total FDI inflows: Nepal vs. comparators (2007-16)**



Source: FDI Snapshot using UNCTAD.

**Figure 3: FDI Performance Index: Nepal vs. comparators (2007-16)**



Source: FDI Snapshot, Computations based on UNCTAD data.

<sup>2</sup> The Nepal Country Private Sector Diagnostic, World Bank (2018)

<sup>3</sup> Throughout this section, the following regional comparators were selected for analysis: Sri Lanka, India, Bangladesh, Cambodia, and Lao PDR.

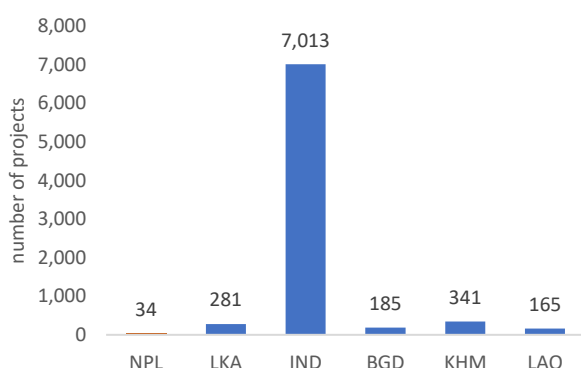
<sup>4</sup> Nepal’s inward FDI stocks rose from 1.03 percent of GDP in 2007, peaking at 5.22 percent of GDP in 2013, before declining to 2.98 percent of GDP by 2016

Note: FDI flows are on a net basis (capital transactions' credits less than debits between direct investors and their foreign affiliates).

Note: The index is constructed by dividing its share of Global FDI by its share of Global GDP.

**Nepal's FDI is entirely comprised of new equity since 2011** (Annex Figure A1.1). This is different from the preceding two years (2009-10), when Nepal received FDI entirely in the form of intra-company loans.<sup>5</sup> The reasons behind this change in FDI composition are unclear. It could be because of a difference in Nepal's central bank's statistical reporting, as it is possible that investments in the form of equity were not reported prior to 2011. Alternately, the change could also reflect new laws in Nepal that somehow restrict the intra-company debt transactions between direct investors and affiliates. Consultations with the central bank would be necessary to provide further insight into this observation. The absence of data points on reinvested earnings suggests that it is likely that Nepal does not disaggregate its equity FDI into more detailed components to include information on reinvested earnings. This is probably due to limited data and difficulties in obtaining this information.

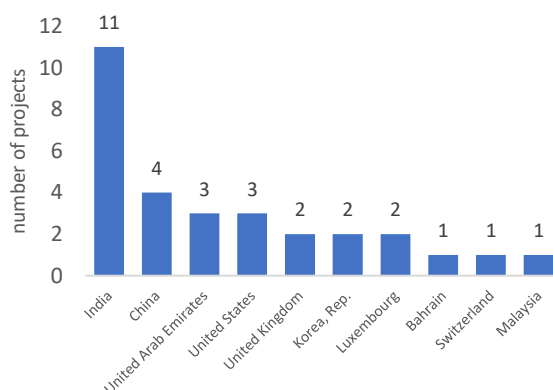
**Figure 4: Total number of greenfield FDI projects: Nepal vs. comparators (2007-16)**



Source: FDI Snapshot using Financial Times fDi Markets.

Note: Data shown is the total number of announced greenfield projects over the time period. See accompanying note for data limitations.

**Figure 5: Nepal's inward greenfield FDI over time (2007-16)**



Source: FDI Snapshot using Financial Times fDi Markets

Note: Data shown is the sum of announced greenfield projects over the time period. See accompanying note for data limitations.

**Nepal received the lowest number of greenfield investments projects compared with peer countries. The top source country of greenfield FDI projects to Nepal is India, followed by China, the United Arab Emirates (UAE) and the United States.**<sup>6</sup> In the past 10 years, Nepal received 34 greenfield projects, about one-fifth of the next lowest recipient in the group, Lao PDR, and a fraction of the 7,013 projects received by India (**Error! Reference source not found.**). India accounts for almost one-third of the greenfield projects in Nepal. The majority of greenfield investments from India have been in pharmaceuticals,

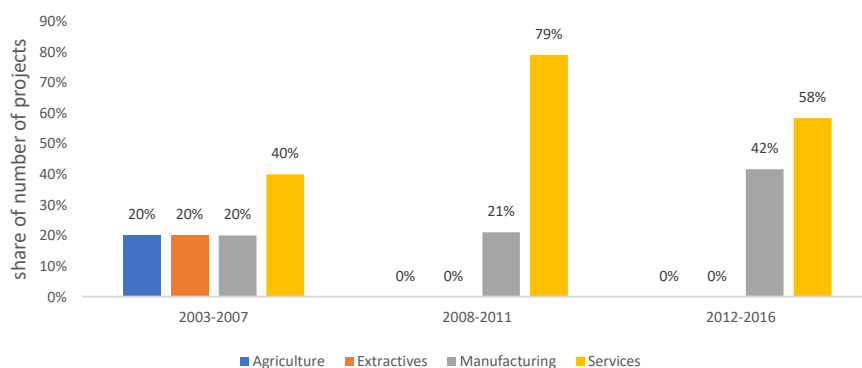
<sup>5</sup> Equity capital refers to the foreign direct investor's purchase of shares of a company in a country other than its home country. Intra-company loans refer to the short- or long-term borrowing and lending of funds between direct investors and affiliate enterprises.

<sup>6</sup> There are two types of FDI projects: Mergers & Acquisitions (M&A) and Greenfield. Broadly speaking, M&A investments refer to the numerous types of transactions that occur as companies merge and acquires assets. Greenfield investment projects are the brand new foreign investment projects in a country. Thus, greenfield investments provide a good measure of the entry of new FDI in a country across time. For this reason, this note presents only greenfield project data for sectoral and project analysis.

financial services, and food and tobacco sectors. Chinese greenfield investments have been split between projects in alternative/renewable energy, and building and construction materials.

**Nepal primarily receives FDI greenfield projects in its services sector**<sup>7</sup> (Figure 6). Between 2012 and 2016, 58 percent of projects were in the services sector and 42 percent in manufacturing. While agriculture and extractives together constituted around 40 percent of projects between 2003 and 2007, post-2007, no new projects were initiated in these sectors. Nepal’s greenfield projects have also become less diverse in more recent years. Between 2003 and 2011, most (23 percent) greenfield projects were in transport and logistics services, followed by 14 percent each in financial services, power, utilities and telecom, and trade and retail. In the past five years, most greenfield projects have been in Nepal’s construction and building sector (31 percent of projects). The share of power, utilities and telecom projects has also increased in recent years. While the share of projects in financial services has remained constant, Nepal has seen an increase in its projects in IT services (Annex Figures A1.2 and A1.3)

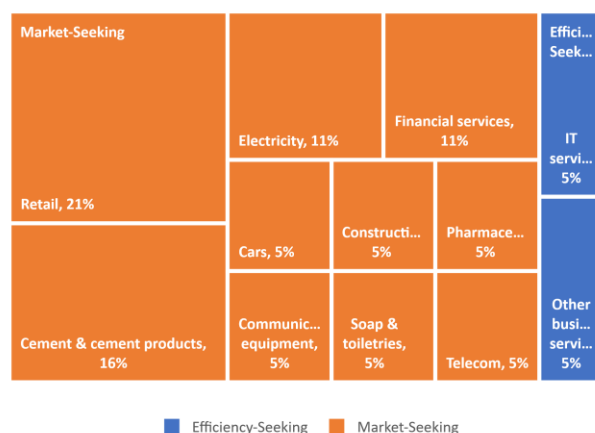
**Figure 6: Nepal’s number of greenfield FDI projects by sector (2003-16)**



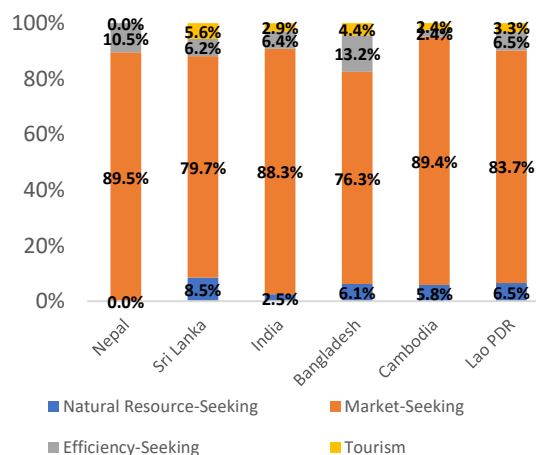
Source: FDI Snapshot using Financial Times fDi Markets.

Note: Data is based on the sum of announcement greenfield projects over the time period.

**Figure 7: Sector share of Nepal’s greenfield FDI by type**



**Figure 8: Type of FDI: Nepal and comparators**



Source: FDI Snapshot using Computations based on COMTRADE and fDi Markets data

<sup>7</sup> Due to data limitations, this is estimated using the number of projects, not the size of projects.







**An analysis of Nepal’s greenfield investments suggests that foreign investors in the country have been mostly market-seeking.** Specifically, Nepal has seen market-seeking investments in retail, cement, electricity and financial services, among others. **Error! Reference source not found.** A fraction (10 percent) of projects have also been efficiency-seeking investments and this efficiency-seeking FDI was in IT and the business services sector (**Error! Reference source not found.**).

**Nepal’s FDI typology trends are consistent with those experienced by its comparators over the same period.** Similar to Nepal, regional peers saw most of their FDI characterized by market-seeking motivations, with very few efficiency-seeking projects. Within the comparator group, Cambodia received the lowest share of efficiency-seeking projects (2 percent) (**Error! Reference source not found.**).

**Box 1: Investment typology**

**Not all FDI is the same. Different types of investment present varying challenges and opportunities for economic growth and development, particularly for a country like Nepal.** The ‘Investment Typology’, as pioneered by John Dunning, demonstrates that different types of investment are driven by varying investor motivations. *Natural resource-seeking investment* occurs when foreign investors establish companies in the host country to access immobile natural resources, often seeking to establish production bases for export. *Market-seeking investment*, on the other hand, is driven by an investor’s intention to establish production facilities in the host economy, with the ultimate intent of supplying goods and services to the host country’s market. The 2017/18 Global Investor Survey found that most investors are market-seeking and report having multiple motivations.<sup>8</sup> *Strategic asset-seeking investment* occurs when an investor seeks control of a firm- or country-specific asset, such as a brand, technologies or distribution network. Finally, *efficiency-seeking investment* is export-oriented and occurs when investors seek to increase cost-efficiency of production, by taking advantage of various location-specific competitive factors, such as a skilled workforce and supply of key inputs such as transport or logistics, etc. Given the mobility of efficiency-seeking investment, global competition for this type of FDI can be fierce and attracting it can be difficult. Efficiency-seeking FDI generally relies on a strong investment climate in the host country and is more responsive to policies aimed at improving the host country’s business environment than other types of FDI.<sup>9</sup>

**Investment motivation typology**

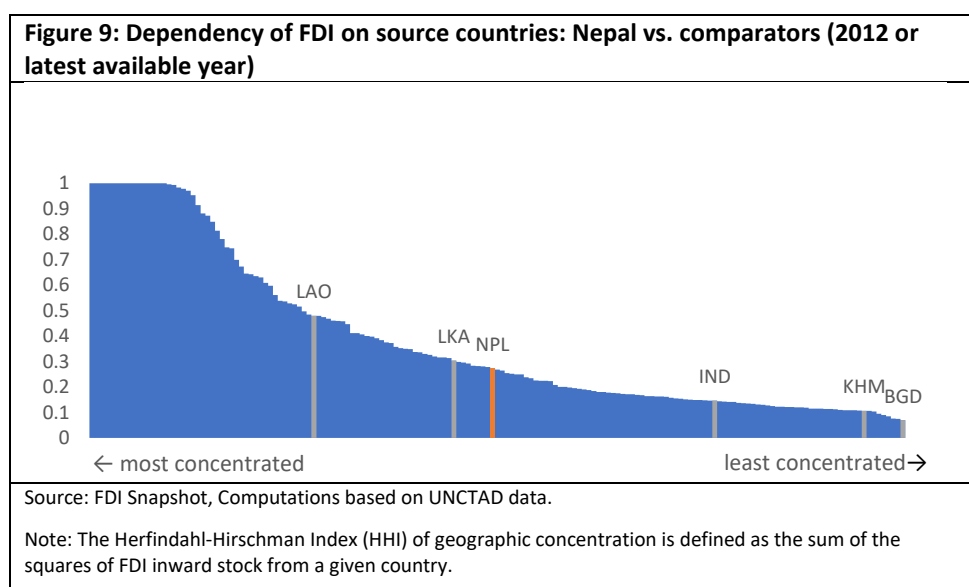
	<b>Natural resource-seeking FDI</b> enters the country to exploit locally available natural resources.	Leads to exporting of natural resources or resource-based products.
	<b>Domestic market-seeking FDI</b> enters the country to gain access to domestic markets	Leads to domestic sales of final products to consumers or intermediates to firms.
	<b>Efficiency-seeking FDI</b> enters the country to save costs in international production networks (offshoring).	Leads to importing of intermediate products and to exporting of final products or intermediates.
	<b>Strategic asset-seeking FDI</b> enters the country to enhance the capabilities of the investing firm by acquiring a firm with technology and brands that have competitive advantage	Leads to importing of intermediate products and to exporting of final products or intermediates.

Source: World Bank. 2018. Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspective and Policy Implications. Washington, DC: World Bank

<sup>8</sup> World Bank. 2018. *Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspective and Policy Implications*. Washington, DC: World Bank.

<sup>9</sup> The 2017-18 Global Investor Survey

**Nepal largely depends on just a few source countries for its FDI.** Based on calculations from bilateral FDI data, the country has a concentration measure (the Herfindahl-Hirschman Index or HHI) of around 0.27 (**Error! Reference source not found.**). Values of the HHI vary between 0 and 1, where it would take the value of 1 in the case where all FDI originates from one country, and approaches zero as FDI is more dispersed across source countries. Of the comparator group, Lao PDR has the most concentrated HHI index for FDI source (with a concentration score of 0.48).



### III. Nepal’s FDI Legal and Institutional Analysis

**Political stability and a business-friendly regulatory environment are the most important factors in reaching a decision to invest** (*Global Investment Competitiveness [GIC] Survey 2017-18*).<sup>10</sup> Unstable, unpredictable or cumbersome regulatory environments can deter investors, despite the commercial attractiveness of the investment and its economic viability. Inefficient bureaucracies, opaque regulations, complex procedures and high transactions costs can undermine a country’s competitiveness. The GIC survey found that more than one-third of surveyed investors identified these factors as a deal breaker. In the same survey, four out of five investors rate transparency and predictability of public agencies and the ease of doing business as important determinants for their decisions on where to locate investment (Annex Figures A2.1 and A2.2).

#### A. Nepal and comparators on different competitiveness dimensions

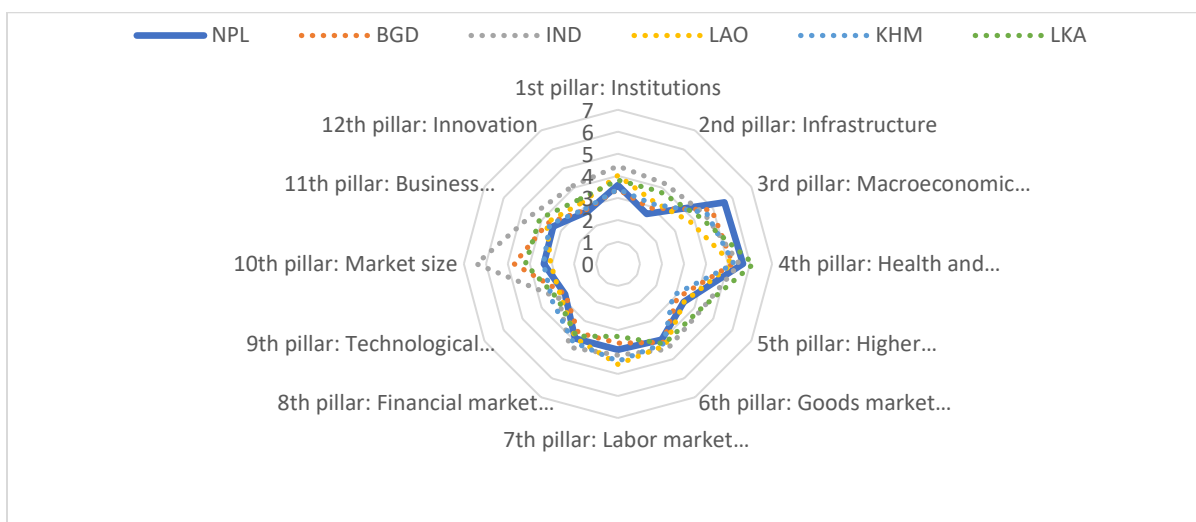
**Nepal ranked 88 in the GCI for 2017-18, an improvement of 10 spots compared with the GCI for 2016-17.** In terms of regional ranking, Nepal stood fourth, after India (40), Bhutan (82) and Sri Lanka (85). The country’s position in GCI is higher than that of Bangladesh (99) and Pakistan (115). However, technological

<sup>10</sup> This is a global survey that was commissioned by the World Bank Group as a companion piece to the Global Investment Competitiveness Report 2017-18. 754 international business executives from both developed and developing countries and covering a wide range of sectors were interviewed.

readiness, efficiency in the labor market, higher education and training remain areas of concern (Figure 10).

**Doing Business indicators also confirm the need to improve the enabling environment.** A weak enabling environment discourages entrepreneurship and investors’ confidence in Nepal’s overall business climate. Nepal ranks 110 on the World Bank’s Doing Business 2019 report compared with its previous ranking of 105 in DB 2018. It scores low on paying taxes (158 out of 190), enforcing contracts (154 out of 190), dealing with construction permits (148 out of 190), the ease of getting electricity (137 out of 190), and starting a business (107 out of 190).

**Figure 10: Global Competitiveness Index, 2017-18**



Source- World Economic Forum, Global Competitiveness Index (2017-2018)

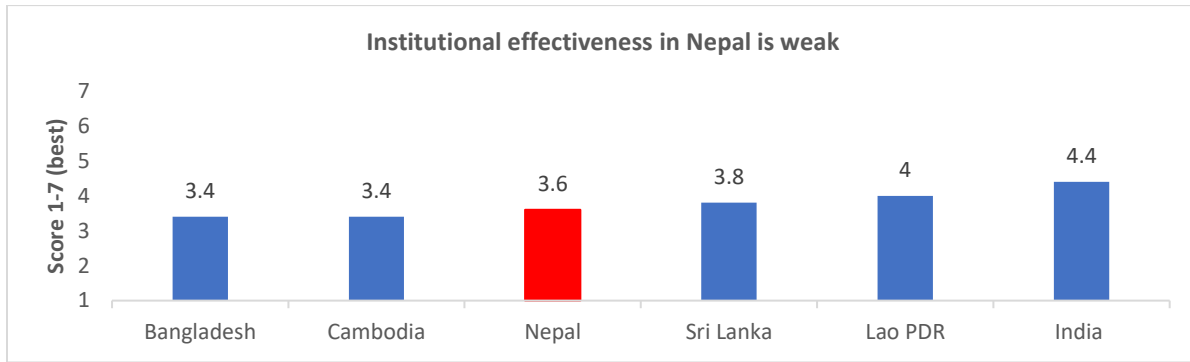
**Nepal has the potential to improve on multiple dimensions of governance.** The 2017 WBG Governance Indicators provide some insights on the performance of Nepal (Annex Table A2.1). Public institutions are a prerequisite for accelerating economic growth, but quality is a major challenge in Nepal. The regulatory quality indicator captures the ability of the government to formulate and implement sound policies and regulations, which are essential for the development of the private sector. Here Nepal stands in the 20th percentile of countries in the regulatory quality indicator, significantly lower than Cambodia, Sri Lanka and India. The rule of law is essential for investments to flow and there remains scope to strengthen it.

#### B. Nepal’s institutional environment

**Nepal’s institutional environment remains a challenge for investors.** Nepal scores 3.6 on a scale of 1-7 for institutional effectiveness in the WEF’s Global Competitiveness Index. While ahead of Cambodia and Bangladesh, Nepal is placed below India, Loa DPR and Sri Lanka.

**The institutional framework for foreign investment in Nepal is complicated.** The performance of Nepal in the Doing Business indicators reflects the institutional complexity of the investment regime. The institutions also suffer from a lack of both financial and human resources. Table 1 provides an overview of the institutions involved in investment policymaking and their implementation in Nepal.

**Figure 11: Institutional effectiveness: Nepal v. comparator countries**



**Table 1: Key institutions responsible for foreign investments in Nepal**

Department of Industry (DoI)	The DoI, under the Ministry of Industry, is the government agency responsible for the administration and implementation of FITTA and promotion of industry in Nepal, particularly for small and medium-sized industries. The Director General of Industry at the DoI has the mandate to approve projects with foreign investment capital below NPR 2 billion (about US\$20 million). <sup>11</sup>
Investment Board of Nepal (IBN)	The Investment Board Nepal (IBN), established in 2011, is a high-level government body chaired by the Prime Minister. The Investment Board Act (2011) gives the IBN a broad mandate to fulfill the role of a public-private partnership (PPP) executing agency, as well as an investment development and promotion body. IBN approves investments above NPR 10 billion (about US\$100 million).
Nepal Rastra Bank	Nepal Rastra Bank (NRB), the central bank of Nepal, was established in 1956 under the Nepal Rastra Bank Act 1955, to discharge central banking responsibilities, including guiding the development of the embryonic financial sector. Foreign investment needs to be registered with NRB. In addition to the DoI, NRB plays a role in approving the repatriation of foreign investment out of Nepal.
Industrial and Investment Promotion Board (IPB)	The IPB, established under the Industrial Enterprises Act 2016, is chaired by the Minister of Industry and has the responsibility to approve foreign investments between NPR 2 and 10 billion (about US\$20-US\$100 million),

**Some of the responsible agencies have overlapping mandates.** For example, the DoI and the IBN have some overlapping functions (e.g., facilitating services). Both the DoI and NRB monitor and approve repatriation requests. The Industrial and Investment Promotion Board (IPB), the DoI and the IBN all have project-approval authority unlike most countries, where there is one approving authority. Having multiple

<sup>11</sup> Nepal Invest Guide 2018.

agencies operating in the same field creates challenges in monitoring, fragments decision-making on investment issues, and results in an inefficient use of resources.

**Federalism under the new 2015 Constitution will have implications for the institutional framework affecting investment.** Article 56 of the Constitution restructures the State into three levels of government: federal, provincial and local. Elections of the representative bodies at all three levels have been completed, but the federal structure is still in the making, with provincial and local government bodies still at the stage of establishment. It will be a while before it becomes clear how these bodies will perform and how they will interact. A few areas may need to be monitored in view of their potential impact on the business environment:

- Revenue-generation powers and strategies of the different levels of government. While the Constitution leaves major revenue sources with the federal government, including income tax, customs and excise, and VAT, it gives the provincial government the power to raise revenue through different sources, including property tax, vehicle tax, tax on tourism and agricultural income, fees and service charges. It also gives the local government the power to raise resources through local tax, business tax, land tax and different fees. There is a possibility of duplication and multiplication of taxes and fees for revenue-generation purposes, which could be aggravated if the central government's transfers are insufficient to finance the provincial and local governments. Such developments could increase the cost of doing business for investors.
- It is not clear how the licensing, permits and inspection processes will be affected by the multiple layers of government, once provincial and local government institutions are in place and are active.
- The Constitution transfers a number of responsibilities to provincial and local governments. Many of these responsibilities relate to infrastructure and service delivery. If these functions are not adequately supported with resources, they may affect the investment climate.

### C. The legal and policy framework for investment

**Foreign investment in Nepal is governed by a number of policies, laws and regulations that overlap in certain respects.** The principal policies and regulations dealing with foreign investment are: (i) the Foreign Investment and Technology Transfer Act 1992 (2048); (ii) the Foreign Exchange (Regulation) Act 1962 (2019); (iii) the Investment Board Act 2011 (2068); and (iv) the Foreign Investment and One Window Policy of 2015. These pieces of legislation have given implementation mandates to the different institutions discussed in the previous section. In addition, investments made by non-resident Nepalis are governed by the Non-Resident Nepali Act (2008) and Non-Resident Nepali Rules (2010) (Box 2).

**The GoN has undertaken several regulatory reforms in recent years.** These include the Industrial Enterprise Act and the Special Economic Zone Act of 2016, and a new policy for intellectual property rights, 2017. The Cabinet approved a draft Foreign Investment Act in June 2017. A new draft Foreign Investment and Technology Transfer Act is currently under discussion within the government.

## Box 2: Policies, laws, regulations and other instruments governing investment in Nepal

- Foreign Investment and One Window Policy, 2015
- Procedural Manual for Foreign Investment in Nepal, 2016
- The Companies Act, 2006
- Environment Protection Act, 1997
- The Foreign Investment and Transfer of Technology Act, 1992 (FITTA)
- Constitution of Nepal, 2015
- Patent, Design and Trademark Act,
- International Investment Agreements of Nepal (IIAs)
- Special Economic Zone Act, 2016
- Investment Board of Nepal Act, 2016
- Industrial Enterprise Act, 2016
- Income Tax Act, 2002
- Labor Act, 2017
- Immigration Rules of 1994
- Banks and Financial Institutions Act, 2006
- Telecommunication Act, 2001
- Electricity Act, 1984
- Foreign Exchange Regulation Act (FERA), 1962
- Foreign Exchange Regulation Rules (FERR), 1963
- Securities and Exchange Commission Act, 1993

In the analysis that follows, the current regulatory framework of Nepal is analyzed along several dimensions: FDI entry, investor protection, expropriation, repatriation, dispute settlement, non-equity modes of FDI, and transaction-specific issues for FDI. The regulatory framework of Nepal is compared with international best practice and this forms the basis for recommendations for further reforms, which are discussed in the following section.

### *FDI Entry*

**As discussed above (Table 1), Nepal has an *ex ante* screening process that requires foreign investors to obtain prior approval before investing.** Three different agencies are responsible for the approval depending on the size of the fixed capital investment. The legal and regulatory provisions governing investment screening are unclear, leaving space for uncertainty on whether pre-approval is required and how it should be obtained. The GoN has issued the Nepal Investment Guide (2018) to inform investors, but the provisions of FITTA (1992), IBN Law (2011) and the Industrial Enterprise Act (2016) do not seem as clear as “the Guide” suggests on the issue of screening. Nepalese laws also rely on the relevant department agencies to issue implementing regulations. Issuing an investment guide is a helpful step toward facilitating investment. However, the guide does not have legal force and cannot by itself fill gaps or remove inconsistencies between different legal provisions.

**The approval process for foreign investment in Nepal is discretionary.** Investors report that there have been instances where the DoI, at its own discretion, seeks recommendations from other authorities. For

instance, the recommendation of the Nepal Telecommunication Authority for foreign investment in the telecommunications sector is sought, even though this is not mandated by the Telecommunication Act, 1997 (2053) or any other Act. This delays the approval process.

**The legal framework for FDI in Nepal imposes a minimum investment requirement** (NPR 5 million or about US\$50,000 since 2012). However, this may not be relevant in many sectors. Investment in the IT services sector, for example, may require very little capital investment but can create good quality jobs and foster export-oriented activities.

**The current legal framework for investment in Nepal imposes a foreign equity cap in many sectors.** For instance, the ceiling for foreign equity investment is: (i) 80 percent in the telecommunications sector; (ii) 70 percent in the insurance sector (for life insurance only); and (iii) 51 percent in services such as accounting and legal services. In the transportation sectors, it is: (i) 49 percent in domestic air passenger services; and (ii) 80 percent in international air passenger services.

**Entry of foreign investment to Nepal is subject to both a negative and a positive list. Misinterpretations and discretionary practices with respect to the two lists have resulted in a more restrictive approach to FDI entry.** FITTA 1992 maintains a long list of sectors that are closed to foreign investment (“negative list”). In addition, foreign investment is allowed only if the activity constitutes an industry as defined by Section 3 of the Industrial Enterprise Act 2016 (“positive list”). A proposed investment must strictly fit the description of an activity that is listed in Section 3. Investors report instances where the DoI has not granted approval for foreign investment as the business in question had not been included as an “industry” by the GoN. This narrow approach of interpretation may cause delays, as well as disqualify investors/investments in certain sectors and create greater levels of uncertainty.

#### *Investor Protection*

**The current framework for foreign investment in Nepal does not provide the core protection guarantees of non-discrimination.** FITTA does not contain the core principles of national treatment and most favored nations. This means that, contrary to international best practice, investors in Nepal are not protected against government action that discriminates in favor of domestic investors, or in favor of nationals of certain countries that Nepal has entered into preferential agreements with. This lack of protection under domestic law may also result in a breach of Nepal’s bilateral investment agreements and free-trade commitments where such non-discrimination guarantees are agreed upon.

**The draft Investment Law of 2017 includes a guarantee of non-discrimination between foreign and domestic investment and extends that to the freedom of movement in the country.** The draft Investment Law guarantees foreign investors equal treatment to Nepali investors throughout the life of their investment. However, it does not provide investors with a most-favored-nation (MFN) guarantee. This means that foreign investors may receive treatment that is less favorable than that offered to other foreign investors who benefit from a preferential trade agreement signed between the GoN and their home country.

#### *Expropriation*

**Different legal instruments protect investors against direct expropriation.** The Constitution of Nepal 2015 under Article 25 guarantees that the state will not expropriate the property of any person except for public interest purposes. The FIP 2015 provides that nationalization may be permissible only for public safety and benefit, provided due compensation is offered. Similarly, the Industrial Enterprise Act (2016)

states that “no industry shall be nationalized”. There have been no recorded cases of expropriation in Nepal. The draft Investment Law reiterates the same commitment.

**However, the scope of protection against expropriation is narrow (i.e., nationalization) and does not extend to indirect expropriation.** It does not make a specific guarantee against “creeping” or indirect expropriation. Rather than direct seizure of property, in recent times, a bigger threat to foreign investors has been indirect appropriation, which are measures (including regulatory measures) that have a similar impact as direct expropriation.

**The protection against expropriation does not provide the guarantee of due process.** The current law provides that nationalization is allowed only for public purposes and against payment of compensation. It is international best practice to ensure that expropriation follows due process, is not discriminatory and is accompanied by prompt, adequate and effective compensation. The timeliness of compensation payments and the nature of the currency (i.e., freely transferable) are very important for investors, particularly in the context of Nepal, where investors have faced foreign exchange issues in the past. Wide protection against expropriation is provided in all of Nepal’s international investment agreements (IIAs).

#### *Repatriation*

**While the legal framework gives investors repatriation rights, the scope of these rights is short of international standards.** Section 5 of FITTA provides the facility to a foreign investor to repatriate the following amounts: (i) the amount received from partial or full sale of shares; (ii) profits or dividends in lieu of the investment; (iii) payment of principal or interest of foreign loan; and (iv) the amount received under an agreement for technology transfer. Repatriation rights, however, do not explicitly guarantee repatriation of payment obtained as compensation from expropriation or any indemnity or compensation received as a result of the final resolution of a dispute.

**While the law does not require prior approval for repatriation of foreign investment, in practice, it is subject to dual approvals by the NRB and the DoI.** The Foreign Exchange Regulation Act (FERA) and associated rules, the Foreign Exchange Regulation Rules (FERR), regulate foreign exchange-related transactions, including foreign investment-related funds transfer and repatriation matters. The regulatory body under the FERA is NRB. Besides the provisions of the FERA and FERR, the circulars issued by NRB are also equally relevant and applicable. The Procedural Manual for Foreign Investment (FIM) in Nepal (2016) requires foreign investors to seek “recommendation” from the DoI before repatriating the proceeds or returns out of Nepal (this includes repatriation of proceedings from technology transfer arrangements as well). However, this recommendation requirement as prescribed in the FIM is used as an “approval” requirement by the DoI. In addition, foreign investors are required to obtain approvals from: (i) the DoI; and (ii) NRB, before they can divest their investment, or repatriate the sale proceeds and dividends. The law does not prescribe the time period within which these approvals can be obtained. Furthermore, whether parallel processes can be carried out in the DoI and NRB is not clear. This means delays can occur and may be lengthy.

**FDI divestment and repatriation are further restricted by a one-year lock-in period.** Pursuant to NRB Circular dated September 11, 2013, a mandatory lock-in period of one year is imposed on foreign investments in either listed or unlisted companies. This lock-in period restricts repatriation rights, contrary to expected investment protection according to international best practice. In addition, foreign nationals working in local industries are allowed to repatriate only 75 percent of their income, which is not considered good practice internationally.



**The draft Investment Law of 2017 improves upon the current FITTA and expands the scope of repatriation.** It gives the investor the right to repatriate the following amounts in a convertible currency:

- a. Amount collected by the sales proceedings of the shares.
- b. Amount derived as the profit or dividend from foreign investment.
- c. Upon the liquidation or dissolution of the company, the remaining amount after the settlement of the entire liabilities following the liquidation or dissolution.
- d. Deposit or interest thereof of the foreign investment.
- e. Amount of the dividend under the technology transfer. (Provided that except the alcoholic industries exporting 100 percent alcohol, for the other alcoholic industries, the amount of dividend as such will not be in excess of the prescribed percentage of total sales price or the net profit exclusive of the prevalent tax.)
- f. Lease rent amount under the lease investment.
- g. Any indemnity or compensation amount received from the finalization of any case, arbitration or any legal process initiated in Nepal.

While it is an improvement over the current FITTA, it still restricts indemnity or compensation from a legal process initiated in Nepal, which raises the question of whether it intends to exclude indemnity and compensation received through a foreign judgement or foreign arbitration from the scope of repatriation.

**The draft Investment Law of 2017 maintains the dual approval requirements for repatriation, while imposing some time limits.** Depending on the size of the actual investment,<sup>12</sup> the foreign investor must apply for prior approval from the relevant authority before applying to NRB for repatriation. However, unlike the current framework, the draft prescribes that the approval authority, as applicable, must approve the application for repatriation within 15 days from the date of receipt of such an application. The draft also states that once the approval requirements are fulfilled and approval granted, NRB “shall have to” provide the repatriation facility to the investor. This seems to suggest that NRB approval would be automatic, but it remains to be seen how it would be implemented in practice.

**Currently, the perception of country risk remains high.** Country risk for expropriation and currency inconvertibility and transfer restrictions remains high in Nepal compared with peer countries (Figure 12).<sup>13</sup>

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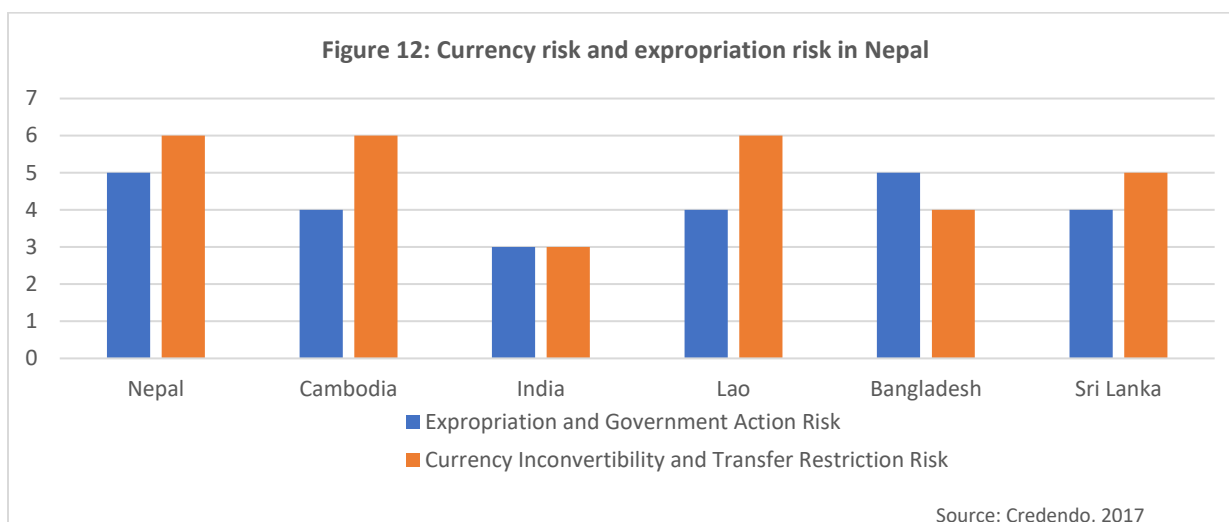
<sup>12</sup> Section 14 of the Draft investment law prescribes that the following bodies shall have authority to approve the following foreign investment.

(A) Investment Board for the foreign investment fallen under the jurisdiction of the Investment Board.

(B) The Department, for the investment up to NPR 5 billion that has not been fallen under the jurisdiction of Investment Board.

(C) The Foreign Investment Board for the investment more than NPR 5 billion that does not fall under the jurisdiction of the Investment Board.

<sup>13</sup> Credendo currency inconvertibility and transfer restriction risk refers to the inability to convert and transfer out of the host country any funds related to the investment. Credendo risk of expropriation encompasses all discriminatory measures taken by a host government which deprive the investor of its investment without any adequate compensation; for analyzing the expropriation risk: events of embargo, change of legal regime and denial of justice are included.



### *Dispute Settlement*

**FITTA does not provide a dispute settlement mechanism between foreign investors and the State.** The measures for settlement of disputes prescribed in FITTA are concerned only with the disputes between the foreign investor, national investor and the industry. In practice, disputes involving a foreign investor are encouraged to be settled through mediation in the presence of the DoI. If the dispute cannot be resolved, cases may be settled either in a Nepali court or in another legal jurisdiction, depending on the amount of the initial investment and the procedures specified in the contract. For investments that exceed US\$5 million, the GoN will permit stipulation of legal jurisdiction other than Nepal in shareholder agreements and contracts. Commercial disputes under the jurisdiction of Nepali courts and laws typically drag on for years.<sup>14</sup>

**The draft Investment Law of 2017 does not address investor-state dispute resolution.** The draft regulates the settlement of disputes between investors (foreign and national). As far as investor-state disputes are concerned, the draft is silent. The draft, however, designates the ministry responsible for industrial matters as responsible for addressing investors' grievances that arise from registration, regulation or monitoring of the investment under relevant laws, or from actions of officials in a single service point center. While this is a welcome development, it does not replace a clear legal definition of the recourse available to investors should they suffer through the action of the State and fail to obtain redress amicably.

**Nepal is party to several IIAs<sup>15</sup> and they form an integral part of Nepal's investment legal framework.** The key provisions in Nepal's IIAs are presented in Table 2. To avoid investment grievances and disputes, it is important for the GoN to ascertain the gap that exists between Nepal's commitments in its IIAs and

<sup>14</sup> Nepal - US Investment Climate Statement, 2017.

<sup>15</sup> IIAs are basically intended to protect and promote global investment and they consist of four main types; namely: (i) bilateral investment treaties (BITs); (ii) bilateral economic, technical, trade, scientific and investment and other provisions agreements (also known as Investment Promotion and Protection Agreements (IPPAs)); (iii) other investment-related agreements involving more than two states commonly known as multilateral investment treaties (MITs); and (iv) Free Trade Agreements (FTAs) containing investment chapters or provisions.

its domestic legal framework on investment; and to determine to what extent the de jure IIA commitments are actually implemented in practice. This “gap analysis” should enable the GoN to undertake the necessary reforms to minimize the gaps and ultimately increase investor confidence, retention and expansion. (Table 3 provides a preliminary gap analysis.)

**Table 2: The key provisions in Nepal’s IIAs**

Type of provision	Description Reference
<b>Definition of investment</b>	All bilateral investment treaties (BITs) reviewed have a broad asset-based definition of investment providing an illustrative list of investments covered. None of the BITs reviewed exclude portfolio investment.
<b>Definition of Investor</b>	All BITs reviewed include a definition specifying “natural person” but no BITs qualify “permanent residents” as investors. All BITs reviewed specify legal entities based on their place of incorporation. However, none of the BITs include “requirement for substantial business activity”. Similarly, none of the BITs define ownership and control of legal entities.
<b>National treatment or equal protection (NT)</b>	All BITs of Nepal provide national treatment (NT). However, in all four BITs reviewed, NT is provided only in the post-establishment phase. One of the features of the new generation IIAs is the inclusion of NT obligation that prohibits discrimination of investors/investments that are “in like circumstances”. No BITs of Nepal reference to NT in “like circumstances”.
<b>Most-favored-nation treatment (MFN)</b>	All BITs reviewed limit MFN obligation only to the post-establishment phase of the investment, i.e., the obligation does not extend to acquisition and/or establishment of investments. As far as MFN exemptions are concerned, four BITs (Germany, Japan, Turkey and the United States) do not cover any advantages accorded to third-country investors by economic integration agreements of various kinds, such as a customs union, economic union, monetary union, free trade agreement, regional integration agreement, etc. Similarly, two BITs (UK, Germany) do not cover advantages accorded by either contracting party to investors of a third State by a double taxation agreement or other agreements on a reciprocal basis regarding tax matters. No BITs reviewed expressly state that the MFN provision does not apply to ISDS provisions found in other treaties.
<b>Minimum Standard of Treatment (Fair and Equitable Treatment)</b>	The BIT with France is the only one that has a qualified Fair and Equitable Treatment (FET) clause. Three BITs (UK, Finland and Germany) have unqualified FET. Only the BIT with France includes an obligation that includes an indicative or exhaustive list of more specific elements. Examples of such elements may contain: denial of justice and flagrant violations of due process; manifestly arbitrary treatment; evident discrimination; manifestly abusive treatment involving continuous, unjustified coercion or harassment; and infringement of legitimate expectations.
<b>Expropriation</b>	All BITs of Nepal cover direct and indirect expropriation. As far as indirect expropriation is concerned, all BITs include a reference to indirect expropriation, whatever the formulation used (“measures having effect equivalent to nationalization or expropriation”, measures tantamount to expropriation, de facto expropriation). However, the only BIT with Germany is the only BIT that contains a definition of, or criteria for determining whether an indirect expropriation has occurred.

<b>Currency convertibility and transfer</b>	All BITs of Nepal reviewed include a provision regarding the free transfer of funds relating to investments (covering outward and/or inward transfers). Only two BITs (Austria, France, Germany and UK) contain an exception that allows the parties to derogate from the free transfer obligation if confronted with (serious) balance of payments difficulties or a threat thereof.
<b>Dispute Settlement</b>	All BITs reviewed establish a mechanism for the settlement of disputes between covered investors and the host State (arbitration and/or domestic courts of the host State). All BITs of Nepal allow for submission to Investor-State Dispute Settlement (ISDS), “any dispute arising from /connected to / relating to / concerning an investment” or uses similar broad formulations. All BITs give their prior consent to ISDS (arbitration) for investors’ claims arising under the treaty. As far as the forums for arbitration are concerned, there is a fair split. All BITs provide an option to submit an investment dispute to arbitration under the International Centre for Settlement of Investment Disputes (ICSID) Convention only.

**Table 3: Gap analysis between the current FITTA Act, the draft investment law and the internationally recognized best practice**

<b>Core Investor Guarantees</b>	<b>FITTA 1992 (Current Law)</b>	<b>Draft Investment Law 2017</b>	<b>International Best Practice</b>
<b>National Treatment</b>	<p>The FITTA Act does not provide any guarantee on NT.</p> <p>The FITTA includes a negative list of reserved and restricted sectors. The foreign investment policy of Nepal, 2015 has revised the negative list. However, these changes are not currently implemented.</p>	<p>Chapter 5 Section 26 and 29 of the draft Investment law provides that:</p> <p>“Emphasis Added” ....</p> <p>(3) A foreign investor having obtained identity card under sub-section (1), shall be entitled for free movement in the part of Nepal except in the prescribed restricted sector of Nepal Government or as per the prevalent law.</p> <p>(4) In the course of movement under sub-section (3) the foreign investor or his/her representatives shall be granted with the National treatment as Nepali National.</p>	<p>National treatment seeks to ensure competitive equality between nationals and foreign investors and requires the host country to extend to foreign investors treatment that is at least as favorable as the treatment it accords to national investors in like circumstances. States rarely grant foreign investors “national treatment” in relation to investment entry (i.e., pre-establishment rights).</p> <p>Once an investor is established, NT requires the state to treat foreign and domestic investments alike and not discriminate against foreign investors. The purpose of NT is to eliminate distortions in competition</p>

		<p>The foreign investment brought in Nepal with the approval under this Act or the prevalent law shall be awarded the NT as the investment made by Nepali citizen till the investment as such continues in Nepal.</p>	<p>and enhance the efficient operation of the economy.</p>
<p><b>Most-Favored-Nation Treatment (MFN)</b></p>	<p>The FITTA act does not guarantee MFN treatment.</p>	<p>The draft law does not guarantee MFN treatment.</p> <p>On the contrary, Section 26 of the draft law provides for an Identification Card (ID card) which may be issued to a foreign investor with the reputation in international sector with the stipulation as an industrially important person (IIP) or industrial promoter of Nepal (IPN). The rationale of this provision is unclear and arbitrary. In practice this may lead to differential or discriminatory treatment.</p>	<p>MFN requires a host country to treat investors from a given foreign country no less favorably than investors from any other foreign country (that is, countries cannot discriminate between foreign investors). MFN helps to ensure that there is no “<i>first-mover disadvantage</i>” when countries negotiate to liberalize, and helps to establish equality of competitive opportunities between investors from different foreign countries.</p> <p>In relation to investment entry, this means that even if a country applies an equity cap, sectoral restriction, or screening requirement on foreign investors, that measure should be applied to all foreign investors in the same way.</p>

			Normally only applies once an investor is already established in the country. However, it is possible to grant “pre-establishment” MFN treatment to investors.
<b>Minimum standard of treatment (Fair and Equitable Treatment)</b>	Nepal’s FITTA does not include any express reference confirming a minimum standard of treatment (MST) in accordance with customary international law.	Nepal’s draft investment law does not include any express reference confirming a minimum standard of treatment (MST) in accordance with customary international law.	The MST standard arises through customary international law and represents the minimum standard of treatment nation states are legally obliged to accord to aliens in their territory. Often, reference is made to fair and equitable treatment (FET) and full protection and security (FPS) standards. These latter standards are often included in the drafting of treaties (sometimes in addition to, and sometimes in elucidation of, the MST). They do not, however, aside from where they are employed as useful labels for describing components of the MST itself, arise under customary international law.
<b>Free Transfer of funds</b>	Subject to Section 5 (2) of the FITTA foreign investor shall be entitled to repatriate out of Nepal:  a. any amount received by sale of the share of foreign investment as a whole or any part thereof.	Chapter 3 - Section 17 provides that Foreign investors can repatriate profits, dividends or any other funds in a freely convertible currency. However, repatriations should have a prior approval from the investment approving body requiring legal and technical formalities.	The World Bank’s <i>Converting and Transferring Currency</i> report summarizes international best practice on foreign exchange laws. <sup>16</sup> The ability to bring in foreign capital, freely convert local currency and foreign exchange, and repatriate investment returns home are fundamental aspects of

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<sup>16</sup> John Anderson *Converting and Transferring Currency: Benchmarking Foreign Exchange Restrictions to Foreign Direct Investment across Economies* (Policy Research Working Paper 6601).

	<p>b. The amount received as profit or divided in lieu of the foreign investment</p> <p>c. Amount received as payment of the principal of and interest on any foreign loan.</p> <p>The same rule is applied to repatriation of amount received under the agreement for transfer of technology.</p>	<p>Once the approval to repatriate is obtained the foreign investor may apply to NRB for obtaining foreign currency.</p>	<p>foreign direct investment. Access to foreign exchange is necessary to pay for imports of goods and services, and being able to use export proceeds freely is an incentive for firms to engage in international business.</p>
<b>Freedom from expropriation</b>	<p>The FITTA does not contain provisions on the guarantee against expropriation.</p> <p>The Constitution of Nepal under Article 25 (2) to (5) provides guarantee against expropriation expect for public purposes with compensation following relevant procedures.</p> <p>The language embodied in the current law is not aligned to best practices</p>	<p>The draft Investment Law under Section 30 provides that foreign investment shall not be nationalized. However, the draft law does not make any reference to conditions under which nationalization may be allowed. Further, no reference to due process and payment of compensation in situations where nationalization is carried out.</p>	<p>It is good international practice that a host country shall not expropriate or nationalize an investment, directly or indirectly, except for a public purpose, in a non-discriminatory manner, in accordance with due process of law, and upon payment of prompt, adequate and effective compensation.</p>
<b>Investor-State Dispute Settlement (ISDS)</b>	<p>Section 7 of FITTA regulates disputes concerning private parties (between foreign investor and domestic investor).</p> <p>Although Nepal is a party to the ICSID and New York Conventions, FITTA does not provide for any form of investor-state dispute settlement mechanism. This is not considered best practices.</p>	<p>The draft Investment Law is not an improvement or positive shift from the FITTA. Section 36 of the draft Investment Law regulates disputes between investors. A foreign investment law should not regulate arbitration concerning private parties, even if one of them is a foreign investor.</p>	<p>ISDS is a form of resolution of disputes between foreign investors and the State that hosts their investment. A good practice provision on dispute resolution enables foreign investors to initiate dispute settlement proceedings against a host State in more than one forum (UNCITRAL, ICSID, etc.)</p>

*Nepal's investment regime and FDI linkages*

**In Nepal, non-equity modes of investment are largely governed by the Foreign Investment and Transfer of Technology Act (FITTA).** Under the FITTA, franchising and management contracts are classified as

“technology transfer”. FITTA defines technology transfer as “any transfer of technology to be made under an agreement between an industry and a foreign investor on the following matters: (i) use of any technological right, specialization, formula, process, patent or technical know-how of foreign origin; (ii) use of any trademark of foreign ownership; and (iii) acquiring any foreign technical, consultancy, management and marketing service.” The definition of “technology transfer” in the draft Investment Law is unchanged and the lacunae that previously existed is not clarified in the new draft. For instance, what constitutes a consultancy service or technological right is not clear. It is also unclear whether software licensing falls under the scope of technology transfer. In case of any other form of technology in other sector of business, which are not defined as an industry under the Industrial Enterprise Act (2016), it is not clear whether the approval of the DoI is required.

**Under the current FITTA, the DoI grants permission to establish franchises or businesses under contract management.** These companies also must go through an additional step of registering the trademark and brand names in Nepal pursuant to the Patent, Design and Trademark Act (PDTA) of Nepal of 1965 to limit any possible infringement. This is because trademark and brand names registered in a foreign country do not automatically qualify in Nepal for trademark protection. In addition, the Foreign Exchange Regulation Act (FERA), 1962 and FITTA govern all repatriation related provisions such as royalty and fees in connection to the technology transfer. Also based on the FERA, NRB (the central bank of Nepal) has the authority to publish and broadcast a public notice for the specified procedures. The draft Investment Law does not provide any clarity regarding this. The concerned authority under both the laws (the draft Investment Law and PDTA) is the DoI. In this context, whether the dual approval (both from the DoI) is required is not clear.

**The involvement of a government agency in private enterprise increases perceptions of risk for a private investor, particularly if there is no legal or regulatory standard in place to support such administrative action.** The FIM provides templates of the transaction documents, such as Joint Venture Agreements, Technology Transfer Agreements and Share Purchase Agreements. It is unusual for a government process manual to publish private-private contracts, and more so as prescriptive formats for the private sector. The templates do not fully reflect business needs. These are complex transaction documents and need to reflect accurately the business arrangements between two private entities. In the current process, the DoI and NRB review these agreements as part of their approval process. Such a review and vetting process increases the time required for the approval process.

**Under the FIM Section 3.2.4, only management agreements that have been approved by the DoI can be used to repatriate fees.** When it comes to making fee payments, FITTA stipulates that the local company should submit to the DoI the amount due certified by an auditor, along with a certificate of payment of income tax on royalties. The underlying aim of this legislation is to ensure that funds are being properly taxed. This is a responsibility that typically falls under the purview of the revenue-collection agency. The intervention of the DoI in approving fee payments as a prerequisite for approval by NRB for the foreign currency payment would require close harmonization of processes and by-laws to avoid bottlenecks.

**The DoI’s interference with commercial arrangements between private parties is ultra vires.** Unlike the equity repatriation procedures, the repatriation of service fees is subject to: (i) approval from NRB, and (ii) a recommendation from the regulator. The recommendation of the regulator is required if the threshold amount is greater than US\$10,000. However, in practice, there have been several reported instances where the DoI interferes with the service fee arrangements agreed upon by the parties to the



commercial arrangement.<sup>17</sup> The DoI does not have any legal basis to interfere in commercial agreements, or to request the parties to reduce the service fee for the same.

**The draft Investment Law has not prescribed uniform or sector specific capping on the royalty and fees in connection to the technology transfer.** However, in practice, a 2 to 3 percent royalty fee is allowed by the authorities. These restrictions are not based on any specific criteria. Under this circumstance, the nature of the service is also used for determining the royalty and fee. Except for the Amended Standards, there is no other legislation, policy or circular that prescribes such capping on royalties or fees. The said Amended Standards has prescribed the maximum limit to the royalty /fee as 10 percent of net profit, or 6 percent of selling price excluding government tax. Even in practice, the authorities do not permit the royalty/fee to be higher than 10 percent. There is no legal basis for such imposition or limitation on the royalty.

#### *Transaction-specific Constraints to Foreign Investment in Nepal*

There are several constraints relating to transactions for foreign investment discussed below that need to be addressed.<sup>18</sup>

**Foreign lenders are subordinated to local banks in priority of repayment.** As NRB does not approve repayment of foreign lenders if there are outstanding unsatisfied debts to local banks, this creates a disincentive to foreign lenders.

**The interest rate cap on foreign currency loans from international financial institutions (IFIs) is fixed at 12-month US\$ LIBOR + 550 bps. This includes the hedging cost.** The cap reduces the attractiveness to foreign lenders. Furthermore, hedging is a separate transaction. The fixed credit spread that applies to all sectors does not compensate for riskier sectors or long-tenor loans.

**The creation of a mortgage of land in favor of foreign lenders needs cabinet approval and the enforcement of security requires a court order.** The process of granting and perfection of security interest becomes very lengthy.

**Foreign lenders are required to set aside capital at the time of signing loan contracts. Commitment fees accrue only after NRB's approval.** This means that the capital allocation remains uncompensated during the time lag between the signing of the contract and disbursement of the loans.

**There are limited risk management products for clients, and capital markets are shallow and underdeveloped.** There are no provisions for micro finance and formal finance institutions to manage the foreign exchange and interest rate risks. Also, the highly volatile and speculative capital market hampers the development of a debt market.

## IV. Reform Recommendations

**The economic analysis in this document indicates that Nepal is attracting FDI below its full potential.** Nepal FDI attraction is not only low in terms of volume, it is also below the quality needed to deliver on the country's economic agenda. This is reflected in a negligible level of efficiency-seeking investment, as

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<sup>17</sup> Making Nepal's National Tourism Strategy Work: Legal Recommendations for Unlocking Investment in Tourism Accommodation Infrastructure June 2016, Celia Ortega Sotes, K. Paige Griffin and Taneem Ahad.

<sup>18</sup> The discussion draws from the Nepal CPSD, World Bank 2018.

well as low diversification in terms of source and sector of investment. Deeper analysis of the institutional environment has identified gaps and constraints in the institutional and legal framework that directly affect investment in the country.

**The proposed reforms have the overarching objective of enhancing Nepal’s competitiveness in attracting investment in key sectors.** The recommendations presented in Table 4 and Table 5 focus on developing a short- to medium-term agenda that moves the needle on the current level of investment attraction. Table 6 presents recommendations for transaction-specific constraints on foreign investment.

**Table 4: Institutional reform agenda recommendations**

Reform Need/Benefit	Reform Priorities
<ul style="list-style-type: none"> <li>- There is a need for a clear vision, strategy and action plan for attracting investment into productive sectors. The strategy could target foreign, non-resident Nepali, as well as domestic, investors.</li> </ul>	<ul style="list-style-type: none"> <li>- Prioritize sectors for investment promotion.</li> <li>- Articulate a clear investment policy statement through a comprehensive process of stakeholder engagement and consultation.</li> <li>- Give a clear mandate and resources for investment promotion to a single agency and task it with developing an action plan for investment promotion including investment aftercare services.</li> <li>- Reform the legal framework for investment to ensure strong investment protection and remove barriers to entry in Nepal’s target sectors and sectors that constitute key input for the targeted sectors.</li> <li>- Establish sectoral public-private dialogue in targeted sectors to identify bottlenecks and guide the preparation of the targeted sectors for promotion.</li> </ul>
<ul style="list-style-type: none"> <li>- Investment services are spread across multiple agencies and there is no clear focus on investment aftercare services.</li> <li>- The first step in attracting investment to less competitive investment destinations is to retain existing investors and encourage expansion.</li> </ul>	<ul style="list-style-type: none"> <li>- Identify overlapping institutional mandates on issues of investment promotion and prioritize for reform, areas of overlap that undermine the provision of services to investors or undermine the implementation of a clear investment attraction strategy.</li> <li>- Consider revisiting the draft Investment Law to address persistent weaknesses identified in this assessment.</li> <li>- Implement an investment retention strategy through well-resourced investment aftercare function and possibly a systemic response mechanism.</li> </ul>

**Table 5: Legal reform agenda recommendations**

Reform Need/Benefit	Reform Priorities
<b>Investment Law</b>	
<ul style="list-style-type: none"> <li>- Adopt a modern investment law</li> </ul>	<ul style="list-style-type: none"> <li>- Replace/revise FITTA 1992/draft Investment Law with a modern investment law aligned to the international commitments and internationally recognized good practices.</li> </ul>

<b>Investment Entry and Establishment</b>	
<ul style="list-style-type: none"> <li>- Ensure entry regime is coherent with country's development objectives</li> </ul>	<ul style="list-style-type: none"> <li>- Eliminate ex-ante screening and approval mechanisms.</li> <li>- Eliminate discriminatory treatment to FDI.</li> <li>- Measure the impact of potential liberalization.</li> <li>- Reduce red tapes and bureaucracy affecting entry/establishment of investment in the country.</li> <li>- Streamline the business establishment processes.</li> <li>- Implement the "one-window system" policies as enshrined in the "Foreign investment and one-window policy" of 2015.</li> <li>- Revise the existing "negative list" and consider not including the negative list a part of the law itself. "Negative lists" are generally added in a document of "inferior" legal value, such as a decree issued under the law.</li> <li>- Abolish the "minimum investment requirements" to encourage the free flow of investments in to the country.</li> <li>- Upgrade from manual filing procedures to online filing systems.</li> </ul>
<b>Investor Protection</b>	
<ul style="list-style-type: none"> <li>- Core principles of good investment legislation (investor rights and asset protection) are absent in the draft Investment Law.</li> </ul>	<ul style="list-style-type: none"> <li>- Add a full set of investor rights and investor protection. A standard range of investor rights, including asset protection and enforcement rights consistent with the country's international investment agreements (IIAs).</li> <li>- Reduce the time and number procedures required in repatriation process. Eliminate additional approval requirements in the repatriation processes.</li> </ul>
<b>Dispute Resolution</b>	
<ul style="list-style-type: none"> <li>- Ensuring an effective access to alternative dispute resolution mechanism.</li> </ul>	<ul style="list-style-type: none"> <li>- FITTA does not provide a dispute settlement mechanism between foreign investors and the State. Ensure that the revised Act includes a dispute resolution mechanism through arbitration, preferably international arbitration.</li> <li>- Avoid the involvement of the DoI in the mediation process for disputes involving foreign investments</li> <li>- Ensure the inclusion of an effective grievance management mechanism to resolve issues faced by investors early on and prevent them from escalating into full-fledged investment disputes.</li> <li>- Overall, adhere to the internationally recognized best practices on dispute resolution framework.</li> </ul>
<b>Linkages</b>	
<ul style="list-style-type: none"> <li>- Integrate NEMs policies into overall foreign investment attraction and retention strategies to ensure policy coherence and effectiveness.</li> </ul>	<ul style="list-style-type: none"> <li>- Avoid government interference in private contractual arrangements. The DoI's interference with commercial arrangements between private parties is ultra vires.</li> <li>- Eliminate discretionary practices for repatriation of proceeds/fees from technology transfers arrangements.</li> <li>- DoI approval requirements for repatriation of fees concerning management agreements.</li> </ul>

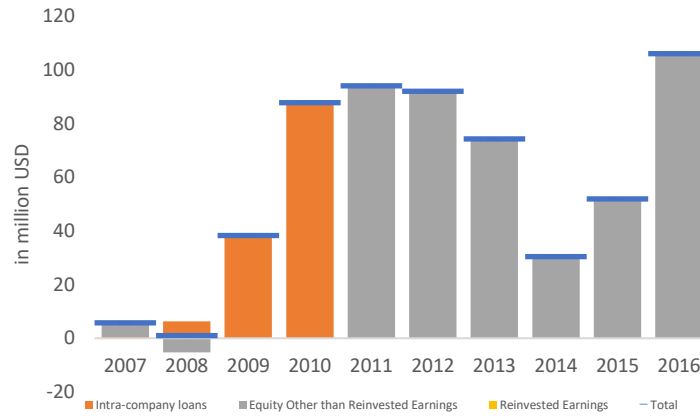
**Table 6: Recommendations for transaction-specific constraints to foreign investment**

<b>Constraint</b>	<b>Proposed remedy</b>
Foreign lenders are subordinated to local banks in priority of repayment	Grant foreign lenders <i>pari-passu</i> treatment with local lenders in priority of repayment
Interest rate cap on foreign currency loans from IFIs is fixed at 12-month US\$ LIBOR + 550 bps. This includes the hedging cost	Reevaluate the rationale behind an interest rate cap. Hedging cost should be separated from the total interest rate cap. Given the different risk profile and loan tenor requirements of different industry sectors, interest rate caps by sector could be explored.
Creation of mortgage of land in favor of foreign lenders need cabinet approval and enforcement of security requires court order	Simplification of granting and perfection of security interest process. For example, requiring the lenders to dispose the collateral instead of repossessing them
Foreign lenders are required to set aside capital at the time of signing loan contracts. Commitment fees accrue only after NRB's approval.	Set a short timeframe for NRB to grant approval (10 days). Permit commitment fees to accrue from the date of submission of the loan documents to NRB but are accruable only after NRB approval.
Limited risk management products for the clients	Permit investors to offer to its clients' risk-management products, such as cross currency swap under which foreign investors would provide a hedge that matches and offsets foreign-exchange liabilities incurred by the client under a non-NPR-denominated borrowing. Another risk management product such as interest rate swap would eliminate the interest rate risk on borrowers' floating-rate liabilities especially in light of a rising interest rate cycle in the United State. This is also consistent with the recent regulation which allows domestic financial institutions to undertake US\$ loans capped at 3.30 percent. Most of these US\$ loans are floating rate by nature and therefore being able to offer interest rate hedging solutions would help these financial institutions to manage their balance sheet more optimally. With foreign institutional investors being able to provide hedging solutions, this would kick start a derivative market onshore which would further attract US dollar inflows from outside investors as they would have an instrument to help them hedge their currency and interest rate risks.
Shallow and underdeveloped capital markets	Enable the issuance of quasi-equity instruments such as convertibles, preference shares to foreign investors. Review stock category, pricing, entry/exit barriers and reduce post-IPO lock-in period for financial investors.
Rules/regulations/directives by NRB and other authorities are available in Nepalese language only.	Publish the relevant directives/information in English.

Source: Nepal CPSD, World Bank 2018.

# Annex 1: Figures on FDI Inflows

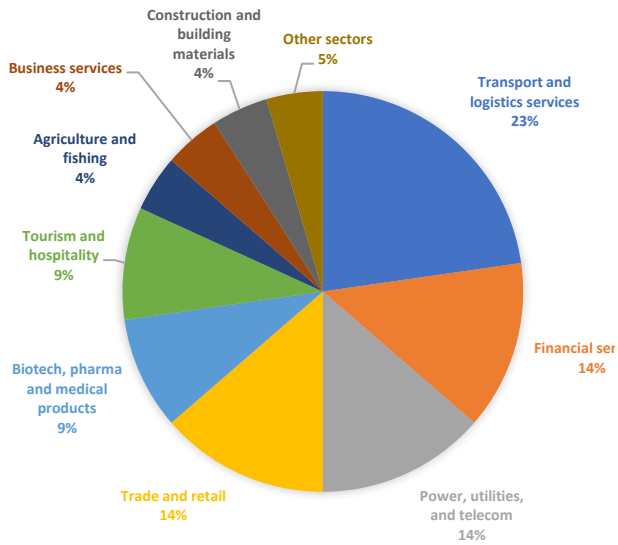
**A1.1: Nepal's composition of inward FDI flows over time (2007-16)**



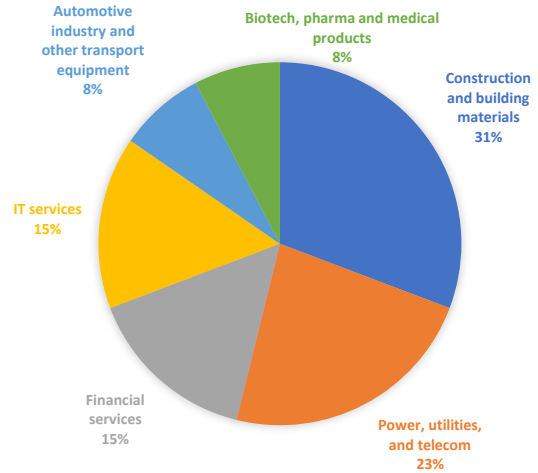
Source: FDI Snapshot using IMF BoP.

Note: Not all economies report FDI flows disaggregated by component for all years. See accompanying note for explanation of negative flows and other data issues.

**Figure A1.2: Detailed greenfield FDI sectoral trends for Nepal (# of FDI projects) (2003-11)**



**Figure A1.3 Detailed greenfield FDI sector trends for Nepal (# of FDI projects) (2012-16)**



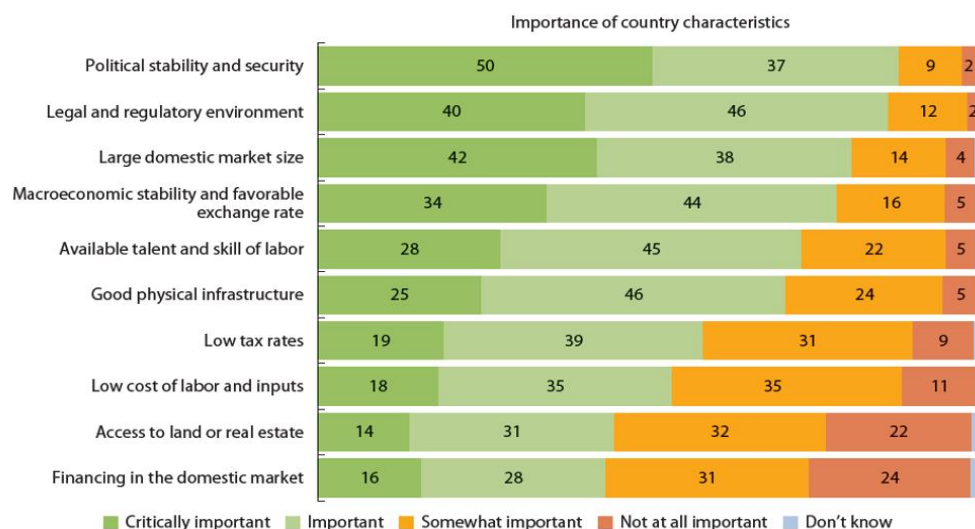
Source: FDI Snapshot using Financial Times fDI Markets.

Note: Data is based on the sum of announcement greenfield projects over the time period.

## Annex 2: Investment Competitiveness

**Figure A2.1: Factors affecting investors' decisions**

Share of respondents (percent)

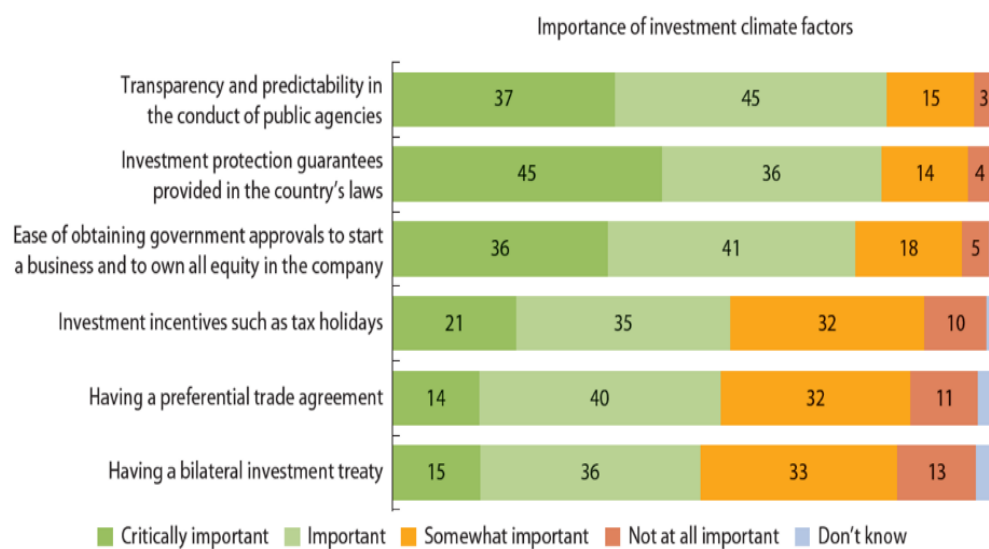


Source: Computation based on the GIC Survey.

Note: Multinational corporation executives were asked how important these characteristics were in their decision to invest in developing countries.

**Figure A2.2: Importance of investment climate to global investors**

Share of respondents (percent)



Source: Computation based on the GIC Survey

**Table A2.1: Governance indicators: Nepal and comparators**

		<b>Bangladesh</b>	<b>Cambodia</b>	<b>India</b>	<b>Lao PDR</b>	<b>Nepal</b>	<b>Sri Lanka</b>
Voice and Accountability	Governance Score	-0.62	-1.16	0.39	-1.75	-0.23	-0.06
	Percentile	30.05	15.76	60.1	4.43	38.92	43.35
Political Stability and Absence of Violence/Terrorism	Governance Score	-1.25	0.17	-0.83	0.43	-0.66	-0.06
	Percentile	10.48	52.86	17.14	63.33	22.38	42.38
Government Effectiveness	Governance Score	-0.74	-0.66	0.09	-0.36	-0.88	-0.15
	Percentile	22.12	25.48	56.73	38.46	18.75	48.08
Regulatory Quality	Governance Score	-0.81	-0.5	-0.25	-0.72	-0.72	-0.13
	Percentile	20.67	32.21	42.31	25.48	25.96	50.48
Rule of Law	Governance Score	-0.67	-1.06	0	-0.88	-0.68	0.06
	Percentile	28.37	13.46	52.88	18.27	27.4	55.29
Control of Corruption	Governance Score	-0.83	-1.29	-0.24	-0.94	-0.75	-0.45
	Percentile	19.23	8.65	48.56	15.87	23.56	41.35

Source: Worldwide Governance Indicators, World Bank 2018.