What are Debentures?

January 15, 2021

In news : Public Issue of Debentures amounting to Rs. 5,000 crores by Power Finance Corporation Limited. opens on January 15, 2021

Key updates

Power Finance Corporation Limited, is one of the leading financial institutions in India, focused on the power sector will open its Rs 5,000 crores public issue of secured, redeemable Non-Convertible Debentures on January 15, 2021.

The base Issue size is Rs. 500 crores with an option to retain oversubscription of up to Rs. 4,500 crores aggregating up to 5,000 crores which is within the shelf limit of Rs 10,000 crores.

The Non-convertible debentures (NCDs) are of face value of Rs 1,000 each

What are debentures?

- Debentures are a type of debt instrument that is not backed by any collateral and usually has a term greater than 10 years. Debentures are backed only by the creditworthiness and reputation of the issuer.
- Both corporations and governments frequently issue debentures to raise capital or funds. Some debentures can convert to equity shares while others cannot.
- In other words, a debenture is a medium- to long-term debt instrument used by large companies to borrow money, at a fixed rate of interest

Various kinds of Debentures

Following are the various types of debentures vis-a-vis their basis of classification.

Based on Redemption or Tenure:

Redeemable and Irredeemable (Perpetual) Debentures

- Redeemable debentures carry a specific date of redemption on the certificate.
- The company is legally bound to repay the principal amount to the debenture holders on that date.
- On the other hand, irredeemable debentures, also known as perpetual debentures, do not carry any date of redemption. This means that there is no specific time of redemption of these debentures.
- They are redeemed either on the liquidation of the company or as per the terms of the issue when the company chooses to pay them off to reduce their liability by issues a due notice to the debenture holders beforehand.

Based on Convertibility :

- **Convertible and Non-convertible Debentures**

- Convertible debenture holders have an option of converting their holdings into equity shares. The rate of conversion and the period after which the conversion will take effect are declared in the terms and conditions of the agreement of debentures at the time of issue.
- On the contrary, non-convertible debentures are simple debentures with no such option of getting converted into equity.
- Their state will always remain of debt and will not become equity at any point in time. It is essential to prepare an agreement that clearly expresses all the terms and conditions.

- **Fully and Partly Convertible Debentures**

- Convertible Debentures are further classified into two –

Fully and Partly Convertible. Fully convertible debentures are completely converted into equity whereas the partly convertible debentures have two parts.

- The convertible part is converted into equity as per the agreed rate of exchange based on an agreement.
- The non-convertible part becomes as good as redeemable debenture which is repaid after the expiry of the agreed period.

Based on Security:

1. **Secured (Mortgage) and Unsecured (Naked) Debentures**

- Debentures can be secured in nature, it may be unsecured in nature.
- A secured debenture is secured by the charge on some asset or set of assets which is known as secured or mortgage debenture and another when it is issued solely on the credibility of the issuer is known as the naked or unsecured debenture.
- A trustee is appointed for holding the secured asset which is quite obvious as the title cannot be assigned to each and every debenture holder.

- **First Mortgaged and Second Mortgaged Debentures**

- Secured / Mortgaged debentures are further classified into two types – first and second mortgaged debentures.
- There is no restriction on issuing different types of debentures provided there is clarity on claims of those debenture holders on the assets of the company at the time of liquidation.
- First mortgaged debentures have the first charge over the assets of the company whereas the second mortgage has the secondary charge which means the realization of the assets will first fulfill the obligation of first mortgage debentures and then will do for second ones.

Based on Transferability / Registration:

Registered Unregistered Debentures (Bearer) Debenture

- In the case of registered debentures, the name, address, and other holding details are registered with the issuing company and whenever such debenture is transferred by the holder; it has to be informed to the issuing company for updating in its records.
- Otherwise, the interest and principal will go to the previous holder because the company will pay to the one who is registered.
- Whereas, the unregistered commonly known as bearer debenture. can be transferred by mere delivery to the new holder.
- They are considered as good as currency notes due to their easy transferability.
- The interest and principal are paid to the person who produces the coupons, which are attached to the debenture certificate. and the certificate respectively.

Based on type of Interest Rates:

Fixed and Floating Rate Debentures

- Fixed rate debentures have a fixed interest rate over the life of the debentures.
- But the floating rate debentures have the floating rate of interest which is dependent on some benchmark rates such as LIBOR (London Inter Bank Offer Rate and the Prime Lending Rate.