

8 Key Differences Between Bonds And Debentures

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Bonds and debentures are very popular debt instruments. However, many people often confuse the two. Here are eight key areas in which they differ.



An organisation may need financing at any time. In fact, funds are a basic requirement for setting up or expanding a business. Most companies prefer debt instruments like bonds and debentures to gather these funds. Although both terms are used interchangeably in many countries, the fact is they are distinctly different. Lets understand the differences between bonds and debentures in this article.

Defining bonds and debentures

Bonds are probably the most common type of debt instrument used by private corporations, government agencies, and other financial institutions. Bonds are essentially loans that are secured by a physical asset. The holder of the bond is considered to be the lender while the issuer of the bond acts as the borrower. The bondholder, or lender, loans money to the borrower with the promise of repayment at the specified maturity date. Generally, the lender also receives a fixed rate of interest during the duration of the bond's term.

Debentures, on the other hand, are unsecured debt instruments that are not backed by any collateral. Rather, the good credit ratings of a company issuing a debenture act as the underlying security. Corporations use debentures as a tool to raise funds for various reasons. For instance, a debenture might be issued when a company is undergoing a cash crunch. On the other end of the spectrum, a debenture can also be issued when a company wants to expand its business with a new project.

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2. Tenure: Bonds can be considered as long-term investments and accordingly, the tenure of bonds is generally long. As for debentures, the tenure is mostly short-term in nature, based on the requirement of the issuing company.

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3. Issuing body: Bonds are generally issued by financial institutions, government agencies, large corporations, and the like. Debentures are issued by private companies in almost all cases.

4. Level of risk: Bonds are regarded as safe havens for lenders because they are backed by some form of collateral. Another reason is that corporations that offer bonds are periodically reviewed and rated by credit rating agencies. Debentures carry a higher risk as they are generally not backed by any kind of collateral. Instead, they are backed solely by the faith and credit of the issuing party.

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5. Rate of interest: Bonds generally offer lower rates of interest since the stability of repayment in the future is high. Moreover, all bonds are backed by collateral too. In comparison, debentures offer a higher rate of interest as they are mostly unsecured by collateral and are backed only by the reputation of the issuer.

6. Payment structure: The payment of interest on bonds is on an accrual basis. Lenders are generally paid monthly, semi-annually, or annually. The business performance of the issuing party has no effect on these payments. When it comes to debentures, the interest payment is done on a periodical basis, which can often depend on the performance of the issuing company.

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7. Convertibility into shares: Bonds cannot be converted into equity shares while certain debentures do offer this facility. Convertible debentures allow holders to convert their debentures into shares if they believe that the company's stock will rise in the future. It has to be noted, however, that convertible debentures pay lower interest rates when compared to other fixed-rate investments.

8. Priority in case of liquidation: In the event of liquidation of an organisation, bondholders are given priority in repayment as compared to debenture holders.

Type of instrument	Tenure period	Risk	Collateral	Interest	Payments
Bonds	Long-term	Low-risk	Required	Lower rate of interest	Accrual basis
Debentures	Short-term	Higher risk	Most are collateral free	Higher rate of interest	Periodical basis

Conclusion

Ultimately, while they may be similar in nature, bonds and debentures are two discrete debt instruments that differ in many ways. While people often get confused between the two and use them interchangeably, it is important to know the differences. After all, the first step towards avoiding investment risks (<https://www.tomorrowmakers.com/stocks/type-risks-you-should-be-aware-when-investing-article>) is to always have the pertinent and correct information at your disposal.

It is important to choose the financial instrument based on what you hope to gain from your investments. Debt funds are appropriate for short-term investment and reduced risk, whilst equity funds are suitable for long-term aims. Achieving a balance between these two might be difficult. The time horizon, risk necessary to attain your goal, risk capacity, and risk tolerance are important parameters to consider when deciding between different instruments funds. Diversify your risk by investing in both debt and equity funds. This will assist you in attaining your many goals, both short and long term. **Check out this Premium Article to learn how to choose the right instrument.** (https://www.tomorrowmakers.com/financial-planning/confused-multiple-debt-instruments-heres-how-choose-right-one-article?utm_source=TM&utm_medium=PAI&utm_campaign=4)

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