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Puerto Rico Lawmakers Remove Interest Cap from $2 bln Bond Deal.

Feb 10 (Reuters) – Puerto Rico's lawmakers have scrapped a statutory cap on the interest the island would pay on a roughly $2 billion bond deal in a bid to make it more appealing to hedge fund investors.

The move comes after a federal judge voided a local law that was key to Puerto Rico's efforts to carry out an orderly restructuring of its public corporations while securing funds for the central government.

The judge's ruling late on Friday that the Recovery Act contravenes federal law, raised questions about the strength of government-backed debt, sending benchmark Puerto Rico's bonds to record lows on Monday.

Eliminating the interest rate cap was "necessary to make viable a successful transaction in the capital markets because of current market conditions and the current value of Puerto Rico general obligation bonds," according to the legislation approved by the Senate.

The amendment eliminated a restriction on how large a discount Puerto Rico could offer buyers that would have established a floor of 93 cents on the dollar, but they kept a provision that limits the average coupon rate to 8.5 percent.

The elimination of the discount restriction removes what would have been a roughly 9.2 percent cap on the yield even though the debt is trading with yields at over 10 percent.

Puerto Rico's House approved the measure on Tuesday after the Senate backed it late the previous day.

Puerto Rico was planning to issue the bonds last year but delayed the sale due to disputes about raising a tax on oil needed to back them. Puerto Rico issued $3.5 billion of debt last March that was largely bought by hedge funds as risk-averse municipal bond investors stayed away.

The island's Government Development Bank (GDB) wanted to work around the interest rate cap by insuring $500 million of the deal, which would have helped lower the average coupon rate. But given the slow pace of negotiations with bond insurers, officials are looking at alternatives.

"We are studying other options, but the best option is to amend the legislation. It's a completely different market from last year," said Melba Acosta, president of the GDB, which acts as Puerto Rico's financing arm.

The GDB also wants lawmakers to index a hike in the petroleum tax to inflation, allowing them to increase the size of the deal to $2.95 billion. The petroleum tax is being used to back the debt.

"Without the (inflation) escalator this is just a patch for the GDB," said one New York based hedge fund investor who may participate in the deal and had been at the legislature all day meeting with lawmakers.

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(Reporting by a Contributor in San Juan; Writing by Edward Krudy; Editing by Ken Wills, Bernard Orr)