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Battle Over Munis Moves to Senate.

WASHINGTON — A bipartisan group of senators is pushing to include municipal bonds in bank-safety rules, the latest wrinkle in a continuing fight over how safe—and salable—the debt of states and localities would be in another financial crisis.

Sens. Mark Warner (D., Va.), Charles Schumer (D., N.Y.) and Mike Rounds (R., S.D.) are set to introduce legislation on municipal bonds this week, according to Senate aides. The bill aims to open the door for big U.S. banks to count municipal bonds as liquid assets under rules completed in 2014 that were designed to ensure Wall Street firms have enough cash during a crisis to fund their operations for 30 days.

The Senate legislation would place municipal bonds on the lowest rung of the "high quality liquid assets" category. That means they would be treated on par with corporate bonds, but not as favorably as under related legislation approved by the House early this year.

"We must ensure a continued and reliable access to capital markets for our local governments," Mr. Warner said in a written statement. "This legislation represents a compromise that achieves that while appropriately balancing concerns for the long term stability of our financial system."

The rules, slated to go into effect next year, are aimed at making banks hold more cash or securities that are easy to sell. The Federal Reserve and two other bank regulators had originally decided debt issued by states and localities didn't make the cut—prompting a backlash from banks, lawmakers and states and localities who warned the move would make the bonds less attractive and raise borrowing costs for municipalities.

The Fed completed amendments in April to allow some investment-grade municipal bonds to qualify. But the two other regulators involved in the rules—the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp.—haven't followed suit.

Aides to Senate lawmakers say their bill was scaled back from the House version to gain broad support for it in the Senate, though it is unclear if there is sufficient time in the remaining year to advance the bill.

Sen. Richard Shelby (R., Ala.), chairman of the Senate Banking Committee, indicated earlier this year that he was reluctant to second-guess banking regulators that originally excluded municipal bonds when they wrote the rules in 2014. But an aide to Mr. Shelby said he wouldn't object to the coming bill as it incorporates changes the Fed already adopted in its version of the rules.

Banks underwrite muni bonds, buy them as investments and sell them to clients. Lenders have played an increasingly central role in the thinly traded, $3.7 trillion market and are now the biggest buyers of municipal debt, according to Municipal Market Analytics Inc., a research firm.

Municipal officials have generally applauded the Fed's willingness to make changes to the rules but say legislation is necessary, largely because banking firms typically hold municipal debt in units that are overseen by the other policy makers involved in the rules, particularly the OCC, which regulates national banks.

Officials at the OCC remain dismissive of including the municipal bonds in the rules and don't believe the debt is sufficiently liquid, according to people familiar with their thinking. The FDIC is waiting until the rules go into effect next year before considering amending its version, according to people familiar with that agency.

While the Senate bill would rank municipal debt similarly to the Fed's amended rules—allowing the banks to count 50% of the bonds' face value when including them in their funding buffers—the legislation would allow banks to include more types of municipal bonds, a Senate aide said.

These include revenue bonds, or securities backed by a specific revenue stream, that comprise the bulk of debt issued by states and local governments but that are kept out of the current Fed version of the rules.

The House bill, meanwhile, is broader than both the Senate bill and the Fed's version of the rules, allowing banks to count 85% of the bonds' face value.

To date, banks have by and large continued to hold lots of municipal bonds despite the rules, in part because they are seen as less risky than corporate debt and are priced competitively to other types of debt, according to bank officials. If interest rates rise this year, banks are expected to begin to pare their muni holdings.

Corrections & Amplifications:
An aide to Sen. Richard Shelby (R., Ala.), chairman of the Senate Banking Committee, said he wouldn't object to the coming municipal bond legislation. An earlier version of this story said an aide to Mr. Shelby said he would support the bill. Also, these comments were made by an aide to Sen. Shelby. Due to an editing mistake, an earlier correction to this story erroneously cited Sen. Shelby for these remarks.

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