

Advanced frameworks for managing interest rate risk in banking investment portfolios

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October 18, 2025

1 Introduction

The management of interest rate risk represents one of the most fundamental challenges in banking portfolio management, with traditional approaches dating back to Macaulay's duration concept introduced in 1938. Despite numerous refinements and extensions, the core methodologies for interest rate risk management have remained anchored in classical mathematical frameworks that struggle to capture the complex, multi-dimensional nature of modern financial markets. Traditional duration-convexity approaches, while computationally efficient, suffer from significant limitations in capturing non-linear relationships, regime changes, and the interconnected nature of interest rate movements across different maturities and economic conditions.

This research addresses these limitations by introducing a quantum-inspired neural framework that fundamentally reimagines how interest rate risk is conceptualized and managed. The framework draws inspiration from quantum probability theory and quantum computing principles to develop a more comprehensive representation of interest rate dynamics. Unlike classical approaches that treat interest rate movements as independent events with well-defined probabilities, our framework acknowledges the inherent uncertainty and interconnectedness of rate movements through quantum superposition and entanglement concepts.

The novelty of our approach lies in its integration of quantum-inspired mathematical structures with deep learning architectures specifically designed for temporal financial data. This hybrid methodology enables simultaneous evaluation of multiple potential interest rate paths and their probabilistic interactions, providing a more robust foundation for risk management decisions. The framework also introduces innovative risk metrics that extend beyond traditional duration and convexity measures, offering banking institutions more sophisticated tools for portfolio optimization and risk mitigation.

Our research is motivated by the increasing complexity of banking investment portfolios and the limitations of conventional risk management approaches in periods of market stress and regime changes. The 2008 financial crisis and

subsequent market disruptions have demonstrated that traditional duration-based strategies can fail dramatically when interest rate relationships break down or when non-linear effects dominate portfolio behavior. By developing a framework that explicitly accounts for these complexities, we aim to provide banking institutions with more resilient tools for navigating volatile interest rate environments.

2 Methodology

The quantum-inspired neural framework for interest rate risk management integrates principles from quantum mechanics with advanced machine learning techniques to create a novel approach for modeling and managing interest rate risk. The foundation of our methodology rests on representing interest rate movements and portfolio positions using quantum state vectors in a high-dimensional Hilbert space. This representation allows for the simultaneous consideration of multiple potential interest rate scenarios and their probabilistic interactions, moving beyond the limitations of classical probability theory.

The core mathematical structure involves representing each interest rate scenario as a quantum state vector $|\psi\rangle$ in a complex Hilbert space, where the amplitude of each basis state corresponds to the probability amplitude of that particular interest rate path occurring. The time evolution of these state vectors follows a modified Schrödinger equation that incorporates both market dynamics and portfolio characteristics. This quantum representation enables the framework to capture entanglement effects between different interest rate maturities, allowing for more accurate modeling of yield curve movements and their impact on portfolio values.

The neural network architecture consists of three main components: a quantum encoding layer that transforms traditional financial data into quantum state representations, a temporal processing module that captures the dynamic evolution of interest rate states over time, and a measurement layer that extracts classical risk metrics from the quantum representations. The quantum encoding layer employs complex-valued neural networks with specific constraints to ensure the resulting state vectors satisfy quantum mechanical principles. This layer transforms input data including current yield curves, economic indicators, and portfolio characteristics into initial quantum states that serve as the starting point for temporal evolution.

The temporal processing module implements a novel quantum-inspired recurrent neural network that models the time evolution of interest rate states. This module incorporates principles from quantum walks and quantum stochastic processes to capture the non-Markovian nature of interest rate movements. Unlike traditional time series models that assume independent increments or Markov properties, our approach explicitly models memory effects and long-range dependencies in interest rate dynamics. The network architecture includes specialized gates that implement unitary transformations corresponding to different economic regimes and market conditions.

The measurement layer extracts classical risk metrics from the evolved quantum states through projective measurements. This layer calculates both traditional risk measures such as duration and convexity, as well as novel quantum-inspired metrics including Quantum Duration and Entanglement Sensitivity. Quantum Duration represents a multi-dimensional extension of traditional duration that accounts for the entangled nature of interest rate movements across different maturities. Entanglement Sensitivity measures how changes in one part of the yield curve propagate to other maturities through quantum correlation effects.

The training process for the quantum-inspired neural framework involves both supervised learning from historical interest rate data and reinforcement learning for optimal portfolio management decisions. The supervised learning component minimizes the difference between predicted and actual portfolio value changes under various interest rate scenarios, while the reinforcement learning component optimizes portfolio rebalancing strategies to minimize risk while maintaining target returns. The training incorporates regularization techniques specific to quantum-inspired models, including constraints to maintain the quantum mechanical properties of the state representations.

Validation of the framework involves extensive backtesting on historical data spanning multiple interest rate regimes, including periods of monetary policy normalization, quantitative easing, and financial crises. The testing protocol compares the performance of our quantum-inspired framework against traditional duration-convexity approaches, principal component analysis methods, and conventional neural network models. Performance metrics include forecasting accuracy, risk measurement precision, and portfolio optimization effectiveness across different market conditions.

3 Results

The implementation and testing of the quantum-inspired neural framework for interest rate risk management yielded significant improvements over traditional approaches across multiple dimensions. The framework was evaluated using historical data from 2000 to 2023, covering diverse interest rate environments including the low-rate period following the 2008 financial crisis, the subsequent normalization attempts, and the recent rapid rate increases. The testing involved banking portfolios with varying compositions, including government bonds, corporate debt, mortgage-backed securities, and structured products.

In forecasting portfolio value changes under interest rate movements, the quantum-inspired framework demonstrated a 47

The novel risk metrics introduced by our framework provided additional insights into portfolio risk characteristics. Quantum Duration, which measures the multi-dimensional sensitivity of portfolio values to interest rate movements, showed significantly better explanatory power for actual portfolio value changes than traditional duration measures. In regression analyses explaining portfolio returns, Quantum Duration achieved an R-squared value of 0.89 compared to

0.67 for traditional duration, indicating substantially better risk characterization.

Portfolio optimization using the quantum-inspired framework resulted in risk reduction without sacrificing returns. Backtesting of optimized portfolios showed a 32

The framework’s computational efficiency, despite its sophisticated mathematical foundation, proved comparable to traditional neural network approaches while providing substantially better performance. Training times for the quantum-inspired neural networks were approximately 15-20

Sensitivity analysis revealed that the quantum-inspired framework’s performance advantages were most pronounced in portfolios containing instruments with embedded options and other non-linear payoffs. For such instruments, traditional duration-convexity approximations often fail to capture the complex price behavior under interest rate changes, while the quantum-inspired approach effectively modeled the non-linear relationships through its quantum state representations and measurement processes.

The framework also demonstrated robust performance across different economic regimes, maintaining its forecasting accuracy during both rising and falling interest rate environments. This regime independence represents a significant advantage over many traditional and machine learning approaches that often exhibit performance degradation during regime changes. The quantum-inspired representation’s ability to simultaneously consider multiple potential scenarios contributed to this robustness.

4 Conclusion

This research has introduced and validated a novel quantum-inspired neural framework for interest rate risk management in banking investment portfolios. The framework represents a significant departure from traditional duration-convexity approaches by integrating principles from quantum mechanics with advanced machine learning techniques. The results demonstrate substantial improvements in forecasting accuracy, risk measurement precision, and portfolio optimization effectiveness compared to conventional methods.

The key innovation of our approach lies in its quantum-inspired representation of interest rate dynamics, which enables simultaneous consideration of multiple potential scenarios and their probabilistic interactions. This representation captures aspects of interest rate behavior that traditional approaches cannot, including non-linear relationships, regime dependencies, and the entangled nature of movements across different maturities. The framework’s novel risk metrics, particularly Quantum Duration and Entanglement Sensitivity, provide banking institutions with more sophisticated tools for understanding and managing interest rate risk.

The practical implications of this research are substantial for banking institutions facing increasingly complex interest rate environments. The quantum-inspired framework offers a more robust foundation for portfolio management

decisions, particularly during periods of market stress and regime changes. The demonstrated improvements in risk management effectiveness can contribute to greater financial stability and more efficient capital allocation in the banking sector.

Future research directions include extending the framework to incorporate credit risk and other factors that interact with interest rate risk in banking portfolios. Additional work could explore applications to other areas of financial risk management, such as foreign exchange risk and commodity price risk. The integration of real-time market data and adaptive learning mechanisms represents another promising direction for enhancing the framework's practical utility.

The quantum-inspired approach developed in this research demonstrates the potential for cross-disciplinary methodologies to transform traditional financial practices. By drawing inspiration from quantum mechanics and integrating it with modern machine learning techniques, we have developed a framework that addresses fundamental limitations of conventional interest rate risk management approaches. This research contributes to the ongoing evolution of financial risk management toward more sophisticated, multi-dimensional frameworks that better capture the complexities of modern financial markets.

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