Journal of Financial Service Professionals
July 2009

The Effective Use of Reverse Mortgages in Retirement

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Abstract: *With the current economic hard times, reverse mortgages are becoming more in demand with retired homeowners throughout the United States. While the reverse mortgage is an appropriate retirement planning tool for many retirees, it generally is considered to be expensive and has some major drawbacks for certain retirees. This article examines the effective use of reverse mortgages in retirement as a supplemental source of retirement income.*

Introduction

The stock market decline of 38.5% in the Standard & Poor's 500 in 2008 was the sharpest annual stock market decline since the Great Depression.[1] In addition to the devastating stock market decline, there has been a decline of 25% in average home values over the past two years across the United States, and home mortgage foreclosures at the end of 2008 were at record highs. Recent housing reports also indicate that one in every six homeowners has mortgage debt greater than the current market value of their homes.[2]

In 2009, as more baby boomers continue to enter their retirement years, many existing retirees and individuals approaching retirement are finding themselves short of the available resources needed to generate an adequate income in retirement. For decades, many Americans have not been saving enough money for their retirement years. According to the Employee Benefit Research Institute, nearly 43% of working individuals over the age of 55 have less than $50,000 in total savings and investments, excluding home equity.[3] The lack of adequate personal savings combined with the collapse in the value of homes and the decline in the stock market is creating some very hard financial times for many retired Americans.

While there are no easy solutions to the current hard economic times or the lack of adequate retirement savings, financial planning techniques that provide for the opportunity for retired Americans to generate additional sources of retirement income are increasing in popularity. This article examines the effective use of reverse mortgages as a supplemental source of retirement income.

The Major Sources of Retirement Income

Of the total aggregate income received by retired Americans, Social Security benefits provide approximately 42.5%, individual savings and personal investments provide approximately 36%, and employer and individual retirement accounts provide approximately 21.5%.[4] Social Security is the major source of retirement income in America for the vast majority of individuals. According to the Social Security Administration, for one out of every three Americans in retirement, Social Security benefits provide 90% or more of their total retirement income, and for two out of every three Americans, Social Security benefits provide more than half of their total retirement income. The average monthly Social Security benefit in January 2009 for retired individuals was only $1,153.[5]

While many retired Americans have very limited incomes, the vast majority of retired Americans are homeowners. According to U.S. Census Bureau statistics, among Americans age 65 and older, 80.5% were homeowners in 2005 compared to 69.1% for the total adult population in the United States.[6] Also, most homeowners over age 65 have considerable equity in their homes. Approximately 50% of Americans over age 65 own their homes free and clear with no outstanding mortgages, approximately 30.5% of retirees own their homes subject to an existing mortgage, and the remaining 19.5% of retirees are renters. For a substantial number of retired Americans, the equity in their homes is their greatest source of net worth, exceeding the investment value of their retirement savings and all other assets. As a result, for many retired Americans, the current economic environment appears to be stimulating an increasing interest in reverse mortgages as a source of additional retirement income.[7]

Many retirees find themselves with very modest retirement incomes because they lack traditional pension income and the available financial resources needed to provide additional income in retirement. Over the past several years, many seniors have suffered the negative results of a declining stock market and lower interest rates on savings, both of which are used by many retirees to supplement Social Security and other sources of retirement income. At the same time, retirees are facing soaring medical expenses, sharply rising home utilities bills, and other increasing expenses. In order to help fill the gap between living expenses and income, an increasing number of retired Americans are exploring reverse mortgages as an available option to add to retirement income.

Reverse Mortgage Features

Reverse mortgages are financial contracts under which homeowners age 62 or older may convert a portion of the equity in their homes to cash, a line of credit, a monthly income for a specified number of years, a guaranteed monthly income for life, or a combination of the available options, without giving up occupancy or title to their homes during their lifetime. The amount of money a senior homeowner receives depends upon the amount of equity in the home, the homeowner's current age, if married, the age of the spouse, and the current interest rate used to calculate the distribution of home equity to the homeowner. With a reverse mortgage, no interest or principal is due to the lender until the death of the homeowner(s) or the homeowner(s)' move(s) from the residence. When either occurs, the loan balance becomes due and the outstanding reverse mortgage loan is paid off by the homeowner, the homeowner's heirs, or from the sale of the home. Any remaining excess equity from the proceeds of the sale of the home is paid to the homeowner or homeowner's heirs.[8] The homeowner also has the option of refinancing the home and paying off the existing reverse mortgage loan balance without moving from the home.

Unlike the conventional home mortgage loan, the reverse mortgage is a nonrecourse loan. Under the terms of a reverse mortgage contract, with any of the loan distribution options, the lender can never collect from the senior homeowner, or his or her heirs, more than the market value of the home when the loan balance eventually becomes due, unless the home isn't sold and the loan is paid off by the homeowner or the homeowner's heirs and the loan balance exceeds the home's value.[9] If the house is sold, the lender must accept the proceeds of the sale as payment in full on the reverse mortgage even if the loan balance is greater than the proceeds of the sale. Also, lending institutions offering reverse mortgages tend to use longer assumptions about the borrower's life expectancy, conservative estimates concerning future home value appreciation rates, and reverse mortgage interest rates that are higher than conventional mortgage rates. As a result, the loan advances generated under the available distribution options in a reverse mortgage tend to be conservative.

From a personal financial planning standpoint, of the available home equity distribution options, guaranteed payments for life in the form of a life annuity are generally preferred by individuals and financial planners. Reverse mortgages are available today in all states and continue to increase in use as part of retirement planning. In recent years, with the stock market decline and the down economy, the use of the reverse mortgage has been increasing sharply. The reverse mortgage has some very attractive aspects for retired homeowners who are in need of additional retirement income; however, reverse mortgages are generally quite expensive and have some severe drawbacks, so they may not be the most appropriate course of action for some retired homeowners. Very careful consideration needs to be given to this complex contract before making the decision to go ahead.

Requirements for Obtaining a Reverse Mortgage

To be eligible for a reverse mortgage a homeowner must be at least 62 years of age and own his or her home free and clear or have a substantial amount of equity built up in the home. For married couples, both the husband and wife must be at least age 62 or older. The property pledged as collateral for the reverse mortgage must be the homeowner's primary residence. Eligible properties may include a single family home, condominium, town house, co-op, manufactured home, or a two to four unit residential building. In 2009, the maximum dollar limit on an FHA home equity conversion mortgage was increased to $625,500.[10]

Since the reverse mortgage contract is very technical and may have a significant financial impact on the senior homeowner and family members, homeowners who obtain an FHA-insured reverse mortgage are required by law to obtain counseling with HUD-approved counselors before they can apply for a home equity conversion mortgage (reverse mortgage).[11] The required counseling is free to senior homeowners and is intended to help the seniors understand how the reverse mortgage works and to help seniors make better financial decisions concerning the appropriate use of a reverse mortgage. The counseling process is supposed to provide the reverse mortgage borrower with unbiased and complete information in order to determine whether the reverse mortgage is the right course of action to meet the senior's needs. After the senior homeowner meets with an approved counselor and discusses the reverse mortgage contract provisions, income options, and costs, the senior homeowner is issued a "Certificate of HECM Counseling," which must be submitted with the application for an FHA-insured reverse mortgage. FHA-insured reverse mortgages constitute the vast majority of reverse mortgage contracts available to and used by senior homeowners. Non-FHA-insured reverse mortgages may provide a higher degree of risk to the homeowner and should be used with caution.

The Costs of Setting Up a Reverse Mortgage

The total closing costs for entering into a reverse mortgage contract are similar to the closing costs required when buying or refinancing a home; however, the closing costs of a reverse mortgage are generally higher. The actual closing costs paid by a senior homeowner for setting up a reverse mortgage will vary by geographic region across the United States but generally will range between 6% and 8% of the amount of the total reverse mortgage loan or the appraised value of the home, whichever is less. All the closing costs are paid by the homeowner at the time of the mortgage closing or are subtracted from the mortgage loan money available to the homeowner. The only exception to this is the home's appraisal fee, which may be required to be paid by the homeowner at the time of closing the reverse mortgage contract, or sooner. The up-front closing costs of a reverse mortgage generally include:[12]

1. **Loan origination fee:** An origination fee is a charge by the lender for preparing the paperwork and processing the loan. In a traditional home mortgage loan, the loan origination fee is based upon the amount of the loan. With the reverse mortgage loan, the loan origination fee is based upon the home's appraised value. If the home is worth less than $125,000, a lender can charge up to $2,500 for this fee. If the home is worth more than $100,000, the fee is limited to 2% of the first $200,000 of the home's value plus 1% of any amount over $200,000, up to a maximum origination fee limit of $6,000. For example, for a home valued at $250,000, the origination fee limit would be $4,500 (2% x $200,000 = $4,000 + 1% of $50,000 = $500). The actual fee charged varies among lenders.

2. **Mortgage insurance premium:** HECM insurance guarantees that the homeowner will receive the promised loan advances and not have to repay the loan for as long as he or she lives in the home. This guarantee is good for life no matter how long the homeowner lives, what happens to the home's future value, or what happens to the lender. This fee is equal to 2% of the HUD home value limit or 2% of the home's appraisal value, whichever is less. An additional .5% is added to the annual interest rate charged by the lender on the loan balance for mortgage insurance premiums.

3. **Title search and title examination, title insurance, and surveying costs:** These fees are similar to the charges incurred in a standard new mortgage or mortgage refinancing and will vary by geographic region and lender.

4. **Appraisal of the home:** The costs charged to the homeowner for the home's appraisal will vary by geographic region and the value of the home. The cost of the appraisal must be paid in cash by the senior homeowner and may not be added to the reverse mortgage loan balance. This fee is often required by the lender at the time of the reverse mortgage application.

5. **Monthly servicing fee:** A monthly reverse mortgage servicing fee is charged to the homeowner by the lender for administering the loan. This fee generally ranges between $30 and $60 per month and is subtracted from the monthly loan advance provided by the reverse mortgage lender.

The actual closing costs paid by a senior homeowner for setting up a reverse mortgage will vary based upon many factors and the specific fees charged by the selected lender. In practice, generally all closing costs required to set up a reverse mortgage are subtracted from the loan advance except the appraisal fee. When the closing costs are subtracted from the amount available for the loan advance, the amount of the lump-sum distribution, the loan amount available for an equity line, or the monthly income available to the homeowner for life is reduced. For homeowners who have relatively low amounts of equity built up in their homes, the closing costs and monthly servicing fees make using a reverse mortgage a very expensive loan. For relatively small reverse mortgage loans, the closing costs are a higher percentage of the home's value and loan advance. With the reverse mortgage contract, the homeowner is still responsible for paying the property taxes, property and liability insurance, and properly maintaining the property as long as the home is occupied by the homeowner.

Money Available from a Reverse Mortgage

Under the reverse mortgage contract, mortgage loan advances are made to the borrower in the form of one of the available distribution options. The income benefits available from a reverse mortgage are determined by: 1) the home's current market value and the senior home-owner's available equity in the home, 2) the senior's age and sex, 3) whether the person is single or married and, if married, the age of the spouse, 4) the current interest rate used in the reverse mortgage contract, and 5) the total mortgage fees and closing costs charged by the lender. Adding the closing costs to the loan amount will reduce the equity available to produce income to the borrower but relieves the retiree of most of the required cash outflow to set up the reverse mortgage.[13]

Reverse mortgage loans may be made available to a qualified senior homeowner in the form of any of the available distribution options or a combination of the available options. Current distribution options under a reverse mortgage contract include an equity line of credit for the homeowner to access as cash needs arise, a lump-sum distribution to the homeowner, or a life tenure plan that provides monthly income for the entire life of the individual(s) in the contract. Non-FHA-insured reverse mortgages also offer a 10-year term monthly annuity option. The income to the borrower from a reverse mortgage under any of the available distribution options is a loan, and as such, the money received by the borrower is not taxable income to the borrower.

A very common distribution option used under a reverse mortgage contract is the monthly income option. Under the "Life Tenure Plan" income option, reverse mortgage loan advances are made to the borrower in the form of monthly income payments for life or as long as the senior homeowner remains in the home. Table 1 illustrates the approximate single-sum advance and the monthly income available for life under a Life Tenure Plan to a senior homeowner using a reverse mortgage. The estimates in Table 1 are calculated for senior homeowners beginning a reverse mortgage at ages 62, 67, 72, 77, and 82 with home equity ranging from $100,000 up to $450,000. The lump-sum advances and the monthly income for life estimates assume that all closing costs are subtracted from the amount of the loan available to the homeowner under the reverse mortgage contract. The reverse mortgage loan calculator estimates are based upon the net amount after the maximum allowable origination and servicing fees, the national average interest rate used for reverse mortgages for the last week in January 2009, and the national average estimates of the other closing costs associated with a reverse mortgage.

TABLE 1

Approximate Money Available from Reverse Mortgage

Age	Owner's Equity in Home	Single Sum Advance	Monthly Loan Advance
62	$100,000	$49,187	$278
	150,000	78,057	442
	250,000	135,297	766
	350,000	193,037	1,093
	450,000	231,893	1,313
67	$100,000	$53,591	$316
	150,000	84,561	498
	250,000	146,001	860
	350,000	207,941	1,224
	450,000	249,611	1,470
72	$100,000	$58,168	$362
	150,000	93,005	569
	250,000	159,945	979
	350,000	227,385	1,392
	450,000	272,739	1,669
77	$100,000	$63,145	$427
	150,000	99,998	666
	250,000	171,338	1,140
	350,000	243,178	1,618
	450,000	291,481	1,940
82	$100,000	$68,258	$521
	150,000	107,129	808
	250,000	182,869	1,380
	350,000	259,109	1,955
	450,000	310,360	2,341

Source: AARP Webplace/Reverse Mortgage/ Loan Calculator Estimates, www.aarp.org.

As can be seen in Table 1, a senior homeowner's age and home equity are important factors influencing the amount of money available from a reverse mortgage contract. A homeowner age 62 with home equity of $100,000 is estimated to receive approximately $49,187 in a lump-sum cash advance or an income per month for life of $278 under a reverse mortgage contract. A homeowner age 62 with home equity of $450,000 is estimated to receive approximately $231,893 in a lump sum cash advance or $1,313 income per month for life from a reverse mortgage. At age 77, a homeowner with $100,000 of equity could receive approximately $58,168 in the form of a cash advance or $427 of income per month for life. At age 77, with home equity of $450,000, the estimated lump sum advance is $291,481 and the estimated income for life is $1,940.

Table 2 examines the estimated lump-sum cash advances and monthly incomes for life available from a reverse mortgage for married couples where both spouses are the same age, where one spouse is five years younger than the other spouse, and where one spouse is 10 years younger than the other spouse. As can be seen in Table 2, the money available from a reverse mortgage is the highest for a husband and wife when they are the same age. When both the husband and wife are age 77, home equity of $250,000 will provide approximately $171,338 in a lump sum advance or $1,140 per month for life from a reverse mortgage. When one spouse is age 77 and the other age 72, $250,000 of home equity will provide approximately $157,028 in a lump sum advance or $978 income per month for life. When one spouse is age 77 and the other spouse is age 67, $250,000 of home equity will provide approximately $145,978 in a lump sum or $856 income per month for life. The reduction in benefits from a reverse mortgage when one spouse is younger than the other is the result of the longer life expectancy of the younger spouse.

TABLE 2			
Reverse Mortgage Income for Spouses of Different Ages			
Owner & Spouse Ages	**Owner's Equity**	**Single Sum Advance**	**Monthly Loan Advance**
Owner & Spouse 77	$100,000	$63,145	$427
	$150,000	$99,998	666
	$250,000	171,338	1,140
	$350,000	243,178	1,618
	$450,000	291,481	1,940
Owner 77 & Spouse 72	$100,000	$58,168	$362
	$150,000	91,288	568
	$250,000	157,028	978
	$350,000	223,268	1,390
	$450,000	267,819	1,668
Owner 77 & Spouse 67	$100,000	$53,568	$314
	$150,000	84,538	496
	$250,000	145,978	856
	$350,000	207,918	1,219
	$450,000	249,588	1,463

As can be seen in both Tables 1 and 2, delaying the start of a reverse mortgage contract to later years increases the amount of money available to senior homeowners. Also, married senior homeowners who are not close in age receive relatively lower amounts as the age difference increases. In addition, homeowners with relatively low amounts of equity receive proportionately less money from a reverse mortgage because the total closing costs for setting up a reverse mortgage take up a greater percentage amount of the available home equity.

The Appropriate Use of Reverse Mortgages

For certain senior homeowners, a reverse mortgage contract may be an appropriate option as a source of additional retirement income. Some of the features of a reverse mortgage may appear to be quite attractive under the right personal financial conditions. The senior homeowners can use the equity in their home to generate additional retirement income and not worry about having to repay the mortgage debt during their lifetime. Also, the amount of the outstanding debt required to be paid on a reverse mortgage upon the eventual sale of the home can never exceed the home's market value.

While reverse mortgages are a unique way by which retired homeowners may supplement their retirement income, the costs of a reverse mortgage appear high. Closing costs required at the time a reverse mortgage contract begins average between 6% and 8% of the home's value or the amount of the loan advance. Also, the homeowner is still responsible for the costs of the home's upkeep and maintenance and repairs, as well as the cost of repairing or replacing major appliances. Another drawback of using a reverse mortgage is that the reverse mortgage contract will liquidate much, if not all of the homeowner's equity, which is the greatest source of net worth for most Americans.

Before entering into a reverse mortgage contract, individuals should consider other financial planning options, especially if the senior homeowner desires to leave the value of his or her home as part of an estate to his or her heirs. A reverse mortgage reduces the value of the borrower's estate and may completely eliminate the estate.

Exploring Other Options

When a senior homeowner needs additional retirement income, another option that may be explored is the use of an intrafamily sale lease back. In the intrafamily sale leaseback, the retired homeowner sells his or her home to a family heir such as a son or daughter, who then immediately leases it back to the (seller) parent. The retiree becomes a renter with a lifetime lease in the home he or she just sold to the family member and would usually also finance the sale of the home with seller financing. When seller financing is used, the amount of the down payment and the terms and conditions of the note may be tailored to the wishes of the senior seller and buying heir. The interest received by the seller on the note would be taxable income to the seller. The interest paid by the buyer to the seller would be tax-deductible mortgage interest expense.[14] As can be seen in Table 3, an intrafamily sale leaseback can be used to generate considerable monthly income to a retired homeowner.

TABLE 3	
Sale Leaseback Net Monthly Cash Flow to Retired (Seller)	
Home purchase price	$250,000
Age of retired homeowner	67
Down payment by buyer heir	$0
Seller financing of $250,000 at 7% for 20 years	
Monthly Mortgage[a] – Rent Due[b] + Taxes, Insurance, Repairs = Monthly Cash Flow	
$1,938 – $1,400 + $500 = $1,038[c]	
[a]Paid by buyer to seller.	
[b]Received by buyer from seller.	
[c]The taxable interest income to the seller for year 1 is $17,312.	

A typical intrafamily sale leaseback for a senior homeowner to an heir would set the amount of the rent per month at an amount less than the required mortgage payment to the seller in the financing agreement. As a result, the retired ex-homeowner receives cash each month and still continues to live in his or her home and is helping a son or daughter or other heir create an estate.

In addition, the seller no longer has the responsibility of paying the property taxes, insurance, maintenance, and repairs on the home as would be still required when using a reverse mortgage. These expenses would now be paid by the buyer (heir) who is able to deduct these expenses as tax-deductible rental expenses. In order to qualify for the available tax deductions for rental property, the entire intrafamily sale leaseback agreement must be an arm's-length transaction. This means that the home's sale price, the seller financing terms, and the rent to be paid to the buyer heir must be in line with the current fair market values for each.[15] As can be seen in Table 4, the heir buying the home from a senior homeowner will have annual before-tax cash outflow as a result of the transaction. The buyer will also have considerable income tax savings and the opportunity for long-term asset accumulation.

TABLE 4	
Buyer Annual Cash Flow and Asset Accumulation in a Sale Leaseback	
Rental Income, Mortgage Expenses and Other Expenses of Buyer	
Rental income	$1,400 × 12 = $16,800
Mortgage payment	$1,938 × 12 = $23,256
Property taxes, insurance, and repairs	$6,000
Before-tax cash flow	–$12,456
Taxable Income/Loss to the Buyer for Year 1	
Annual rents:	$1,400 × 12 = $16,800
Less:	
Interest expense	$17,312
Taxes, insurance, etc.	$6,000
Depreciation	$7,272
Total deductible expenses for year 1	$30,584
Taxable loss year 1	($13,784)[a]
Taxable loss $13,784 × tax rate 28% = tax savings $3,860 after-tax CF =	–$8,596
Loan balance reduction year 1	+$5,947
Home value appreciation year 1 @ 3%	+$7,500
Buyer's annual after-tax cash flow plus asset accumulation	+$4,551
[a]Subject to the Passive Limitation Loss Rule.	

The most difficult part of an intrafamily sale lease-back might be finding an heir who is willing and financially able to buy the home and pay the monthly mortgage payments and home-related expenses. The family member buying the retiree's home in the intrafamily sale leaseback must be in a financial position to afford an annual cash outflow to the senior homeowner. The specific amount of the cash outflow can vary depending upon the financial ability of the buyer, the needs of the retiree, and the value of the home being purchased. The best candidate for buying a home from a senior homeowner under the intrafamily sale leaseback agreement is an immediate family member such as a son or daughter.

In addition, a self-canceling installment note (SCIN) may be used between the buyer and the seller in an intrafamily sale leaseback agreement. As part of the agreement, the senior homeowner receives a SCIN from the heir(s) buying the senior's home. Under a SCIN, the heir's obligation to make the principal payments on the note automatically expires if the senior dies with an outstanding loan balance remaining on the intrafamily sale leaseback agreement. Using a SCIN as part of the agreement may make the transaction more appealing to the buying heir(s), and the unpaid balance of the note is not included in the taxable estate of the senior.

When looking at the economic well-being of the entire family unit, including the retiree and the purchasing heir(s), the intrafamily sale leaseback agreement— when compared to the reverse mortgage—may be more beneficial in preserving wealth and reducing overall costs, and may provide greater net retirement income to the senior homeowner. When the participants in the intrafamily sale leaseback agreement are considered as one economic unit, the benefits to the total family may exceed the net benefits from a reverse mortgage.

Conclusion

The reverse mortgage can be used to help senior homeowners who have considerable home equity increase their retirement income. The reverse mortgage is becoming more widely available and more in demand by retired homeowners throughout the United States. However, entering into a reverse mortgage contract when the retired homeowner desires to leave the home as part of his or her estate to heirs should be done only after exploring all other available options and the total costs and benefits of the options.

The costs of a reverse mortgage are generally considered high because of the substantial up-front closing costs and may be considered very expensive when used in the short term or by individuals who have relatively low amounts of home equity. Also, when leaving an estate to heirs is a high priority, a reverse mortgage may not be a viable option to increase retirement income.

Financial planners need to explore the reverse mortgage as well as other available options with retired homeowners to help them fulfill their retirement needs and estate transfer wishes. An intrafamily sale leaseback arrangement may be more beneficial to a retired homeowner. The costs to set an intrafamily sale leaseback agreement are generally minimal and the provisions of the sale, financing, and lease agreement can be tailored to meet the needs and desires of the parties involved while maintaining an arm's-length transaction for tax purposes. A major obstacle to using an intrafamily sale leaseback agreement is that many retirees may not have a close heir who is financially able to participate in the arrangement.

Under the appropriate conditions, either a reverse mortgage or an intrafamily sale leaseback may be an effective devise to supplement retirement income needs.

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